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BUSINESS VALUATION

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WHAT IS A BUSINESS WORTH?

This question can only be answered by addressing other related questions, specifically: *Who's asking and for what purpose?*

From the perspective of the owner, prospective buyers, the Revenue Authorities, lenders and divorce & bankruptcy courts, the value of a business for purposes of a sale, estate planning, orderly or forced liquidation, gifting, divorce, etc. can be vastly different.

Intrinsically tied to the various purposes of valuation are numerous definitions of "value." Here are a few examples:

Investment Value – The value an acquirer places on a business based on a future return on investment determined by assessing past and current performance, future prospects, and other opportunities and risk factors involving the business.

Liquidation Value – The value derived from the sale of the assets of a business that is closed or expected to be closed following the sale.

Book Value – Book value is the difference between the total assets and total liabilities as accounted for on the company's balance sheet.

Going Concern Value – Used to define the intangible value which may exist as a result of a business having such attributes as an established, trained and knowledgeable workforce, a loyal customer base, in-place operating systems, etc.

Fair Market Value

For the purpose of this article, the focus will be on transaction related valuations. Fair Market Value ("FMV") is the most relevant definition of "value" and is of the most interest to business owners. The more knowledge business owners and prospective buyers have about the valuation process, the more likely they will come to an agreement on a purchase price.

FMV is the measure of value most used by business appraisers, as well as the Revenue Authorities and the courts. FMV is essentially defined as "the value for which a business would sell assuming the buyer is under no compulsion to buy and the seller is under no compulsion to sell, and both parties are aware of all of the relevant facts of the transaction." The following factors are usually considered in establishing estimates of FMV:

1. The nature and history of the business.
2. The general economic outlook and its relation to the specific industry of the business under review.
3. The earnings capacity of the business.
4. The financial condition of the business and the book value of the ownership interest.
5. The ability of the business to distribute earnings to owners.
6. Whether or not the business has goodwill and other intangible assets.
7. Previous sales of ownership interests in the business and the size of ownership interests to be valued.
8. The market price of ownership interests in similar businesses that are actively traded in a free and open market, either on an exchange or over-the-counter.

What is Goodwill?

An important element of value, when it exists, is goodwill. The Revenue Authorities and business appraisers usually define goodwill as follows, "In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business.

The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value for the tangible assets exceeds the net book value of such assets.”

Valuation Approaches and Methods

Exploring valuation techniques requires an understanding of the tools available. Which tools are utilized depends in part on the purpose of the valuation and the circumstances of the subject company. Generally there are several approaches to valuing a business. Within these approaches, there are several different methods. Listed below are the three major approaches along with some examples of specific methods that fall under each category.

- **Income Approach**
 - Discounted Cash Flow Method
 - Single Period Capitalization of Earnings Method
- **Market Approach**
 - Comparable Publicly Traded Company Analysis
 - Comparable Merger & Acquisition Analysis
- **Asset-Based Approach**
 - Adjusted Net Asset Method
 - Excess Earnings Method

All of the above methods and approaches are frequently used in business valuations.

Normalizing the Financial Statements

Before the approaches and methods above can be applied, it is necessary to analyze and normalize both the income statement and balance sheet of the business for the current and past periods selected to form the basis of the valuation.

Normalizing the Income Statement

Normalizing the Income Statement generally entails adding back to earnings certain personal expenses, non-recurring and non-cash items. Examples of these “add-backs” could include depreciation, amortization, auto, boat and airplane expenses, one-time extraordinary expenses and other excess expenses such as owner’s salaries and family member’s salaries that are above fair market value, travel and entertainment, bonuses, etc. Owners usually tend to be extremely liberal when normalizing the income statement in order to bolster earnings, which can artificially inflate valuation. Each item must be carefully analyzed and scrutinized to insure that the normalization process is credible.

Normalizing the Balance Sheet

Normalizing the Balance Sheet includes adjustments that eliminate non-operating assets and other assets and liabilities that are not included in the proposed transaction, and therefore the valuation. The book value of the assets will be adjusted up or down to reflect their fair market value. Inter-company charges will also be eliminated. Inventory may be adjusted upward or downward based on prior accounting procedures and/or obsolescence. Accounts receivable may also require an adjustment based on an analysis of collectibility.

Relevant Terminology:

EBIT – An acronym for earnings before interest and taxes

EBITDA – An acronym for earnings before interest, taxes, depreciation and amortization.

Capitalization Rate – Any divisor that is used to convert income into value. This is generally expressed as a percentage.

Discount Rate – The rate of return that is used to convert any future monetary gain into present value.

(Note: when determining FMV, the earnings stream selected to be capitalized or discounted should be normalized.)

Summary

Even with all the terminology and definitions discussed above, the answer to the original question has not yet completely been answered: What is the company worth?

The value driver of a business is the ability of the entity to generate future cash flow or earnings. Business appraisers will assign an appropriate capitalization rate (or multiple) to a selected earnings stream to derive an overall value for a business. The value of the net assets of the business will be compared to the cash flow valuation and may be adjusted upward or downward. For example: if the earnings based valuation is less than the net asset value, an upward adjustment may be in order. Conversely, if the net assets are negligible, a downward adjustment is more likely to occur.

Many appraisers typically use a common range of multiples to arrive at a "ballpark" indication of value (for example, 4 to 6 times EBITDA). While this approach is commonplace, an in-depth valuation of the subject company will produce a more accurate result. There are too many intangible factors to be considered to rely solely on the capitalization of earnings. Of course, the ultimate value of a company will be determined by the marketplace, which can greatly differ from a seller's expectation, as well as the expectations of potential acquirers.

It is not uncommon for business owners to have an inflated sense of value of their company. This could be due to a variety of factors including emotional attachment to the business, unwillingness to accept the impact of the risk factors of the business, outside influence from previous market conditions, incorrect conclusion of normalized earnings, comparable transactions, etc. Conversely, acquirers often undervalue businesses. In their quest to "buy right" they often end up paying a lower multiple for a company with serious negative factors, while passing up on higher multiple opportunities, which, due to the quality, are actually better buys.

Valuation is a complex process. Owners and buyers will be well served if they rely on professional advisors such as their accountants, business appraisers, intermediaries or investment bankers

COMMON MISTAKES IN BUSINESS VALUATION

- Not really defining what is for sale. Are all of the trademarks, copyrights, patents or other intangibles included in the sale price? For example, in the sale of a fast food chain, are the proverbial "secret recipes" included in the transaction price?
- Forgetting favorable attributes-- A stone quarry may have one of the few available permits to excavate in a particular state or county, or a distribution business may own exclusive territorial rights, etc. These attributes should result in a premium on the valuation of the business.
- Not discovering the true level of earnings - Making accurate adjustments to earnings (normalization) is essential to recognizing the real earning power of a company.
- Not finding the value detractors - Nothing is perfect. Is the business concentrated in just a few customers? Is the equipment antiquated? Are the financial statements in disarray? Will significant capital expenditures be required in the near future? Consideration must be given to the impact of potential value detractors such as those listed above.
- Forgetting the real value of the assets - It is easy to forget that particular balance sheet items may be worth more than their indicated book values. For example, capital equipment may have been depreciated to an amount significantly under its actual value.
- Selecting the incorrect earning period to capitalize or discount - Are they last year's earnings, an average of the past few years, or merely a projection of next year's earnings? Historical earnings cannot be used if future earnings are expected to be substantially different.
- Choosing an inappropriate multiple or capitalization rate - Is it applied to EBIT or EBITDA and why? How was this multiple derived? Today's EBITDA multiple is not necessarily tomorrow's!
- Not considering current market conditions - The current business climate and economy can significantly impact valuations. Changes in overall market conditions can cause valuations to substantially fluctuate. This point can clearly be seen in the recent devaluation of Internet companies.

VALUING A BUSINESS FROM A BUYER'S PERSPECTIVE

Often times, public company data is used when attempting to value a privately-held firm. This comparison usually requires substantial adjustments to offset the risks inherent in the privately-held or closely-held company. These potential risk characteristics are usually elements that are overlooked by sellers, but not by potential buyers.

Sellers obviously look at their companies much differently than do prospective acquirers. Owners and company officers tend to place value on different factors than does a buyer. However, when it comes time to sell, it's important that the seller consider those factors that are important to a buyer.

Interviews with buyer prospects reveal that they are concerned with, and influenced by, the factors outlined below. They are often the basic considerations that determine whether they actually purchase the business, as well as the price they are willing to pay. It is the buyer's evaluation of these factors that can make or break a possible sale.

Buyers tend to look at these elements as risk factors. They also look at the expectation of future earnings. The following characteristics affect, both positively and negatively, the future earnings potential of and the risks involved in a target business.

Historical Earnings

The history of a company's earnings is very important to a prospective buyer. A long history of stable, and hopefully increasing, earnings is a positive factor in whether the buyer will pursue the acquisition. Conversely, a brief history or inconsistent earnings will certainly be a negative factor. A short time frame (for example, a company that has been in business for a year or less) and erratic earnings present obvious risk factors.

Entrepreneurs often underestimate the costs (and time) necessary to get the company to a profitable level. Start-ups are difficult to sell under the best of circumstances. The next time period in the life of a business is after three years, at which point there is some history, and a track record is beginning. The third period is usually after the company has been in business for a minimum of five years. Now the company has a track record and a reasonable history of performance.

Growth Prospects for Both the Business and Industry

If the buyer is from the same industry, then he or she should already have the answers to these questions. If the buyer is from a different industry or business type, then these are very important issues. Certainly, no one can predict the future, so these issues are subjective at best. Thanks to the Internet, however, information is much easier to obtain than ever before. If the buyer perceives the target business to be in a growth industry, then the valuation can be considerably higher than one that is not.

Depth of Management

Just as a skilled and well-trained workforce commands a higher value, so does strength and depth of management. Generally speaking the smaller the company, the less depth of management. A business that is primarily dependent on the owner or a manager will bring substantially less in the marketplace than one that has key management in place. Many prospective purchasers also want more than one layer of experienced management in place.

Some buyer concerns about management

- Will top management stay beyond any contractual periods?
- Is the current management motivated and what incentives do they need?
- Are current management values, etc., consistent with the buyers?
- Does current management have the leadership skills to move the company forward?
- Is the depth of current management sufficient to fulfill projected growth plans?
- Is current management able to handle change?

Employee Stability

Well-trained and skilled employees are a big asset. National studies indicate that over 50 percent of employees are unhappy with their jobs. Having a skilled and happy workforce in place is especially important for new owners without industry experience. Prospective purchasers are equally concerned with the high-cost of finding, hiring and training new employees. For these reasons, companies with a well-trained, skilled and contented workforce will

command a premium value. Companies that utilize low-skilled employees and have high employee turnover will bring a much lower price.

Terms of Sale

Is the company solid enough to support debt financing as opposed to equity capital? Are the company owners, if privately owned, willing to help finance the acquisition? The answers to these questions impact value. The availability of capital can be a significant factor in increasing the value to an acquirer.

Diversification

Diversification has two elements. The first is the diversification of products or services. Can they be readily expanded? Do the products or services just fill a niche and therefore limit expansion? What limitations does the company have, such as customer or supplier restrictions? The second element is geographic. Providing the product or service on a national level certainly increases value and decreases the risk to the buyer. Conversely, only local or regional distribution reduces value and increases risk.

Industry characteristics that increase value

- Industries with strong trade or professional associations
- Industries with low failure rates
- Industries with any type of regulation, licensing, patents - anything that might restrict the amount of competition
- Industries with established products or services coupled with stable pricing

Competition

Companies in very competitive industries may have less value than ones with little or moderate competition. Heavy competition can lead to lower prices creating lower volume and profits. However, concentrated competition, for some businesses, such as auto dealers clustering in auto malls, can actually increase sales.

Business Type

This element is most likely to be in the "eyes of the beholder." The buyer's perception of risk may focus almost entirely on the type of business or industry. Businesses that are easily started obviously have less value than those that are equipment/capital intensive or require very skilled workers or specialized knowledge. Industry trends can play an important role in the value of a business.

Some industries seem to be simply more "popular" than others. Manufacturing represents less than 10 percent of all businesses, but the demand for this type is very high. The demand for retail businesses that must compete with the large "box" stores is very low.

Location and Facilities

A well-located office and/or facility will, at least psychologically, increase value. Well-maintained fixtures and equipment will definitely increase value. Everything else being equal, an attractive plant with well-maintained equipment located on the "right side of the tracks" will have a higher value than one without these advantages.

Summary

The business characteristics described above outline some of the pitfalls or risks in using public company data when looking at the privately-held or closely-held company. Buyers obviously - and sellers certainly - should be aware of the factors or characteristics described above as they heavily influence the ultimate value of a company, the time it takes to sell, and sometimes whether it will sell at all.

NORMALIZING THE STATEMENTS ISN'T ALWAYS NORMAL

Definitions

Expense - anything that a company buys that has an economic life of less than one year. It shows up immediately on the income statement.

Capitalized items - have an economic life of one year or more and the cost is moved to the balance sheet, and then these costs can be written down by depreciation or amortization over time.

Normalized financial statements - statements that have been adjusted for items not representative of the current status of the business. Normalizing statements could include such adjustments as a non-recurring event such as attorney fees expended in litigation. Another non-recurring event might be a plant closing, or adjustments of abnormal depreciation. Sometimes owner's compensation and benefits need to be restated to a competitive market value.

As Americans have discovered over the past few months, many public companies will stop at nothing to maximize earnings and therefore increase the price of their stock. Most private businesses take the opposite tack and try to minimize earnings to reduce their tax liability. After all, they don't have Wall Street and shareholders to please. The less their tax obligation - the more discretionary money they have personally available.

Unfortunately, when it comes time to sell, it's also time to "pay the piper." However, many business valuation professionals are aware of this incongruity, and make allowances for it in their approach to valuing the company. It is called "recasting" or "normalizing" the statements.

Due to all of the recent publicity concerning the accounting irregularities among some of the country's largest companies, Fortune magazine stated that America has lost its way. In fact, the magazine's exact words were: "Stop the abuse of restructuring charges. The cost of things like plant closings and lay-offs is just part of doing business and should count as an operating expense, not as a special one-time charge." These words were specifically addressed to very large, publicly held firms, but the examples can carry over to smaller privately held companies.

For example, determining what is capitalized and what is expensed can be a gray area. Some costs are clearly expenses, and others clearly should be capitalized. But there can be a fuzzy distinction among other expenses. Research and development is a gray area. It develops new products that, in turn, hopefully create future profits. Despite the long-term outlook for R&D, many companies expense this item. Another example is advertising. Its purpose is to create long-term brand awareness and to sell products or services in the future. However, advertising is also normally expensed. By expensing these items, the profits of the company decrease, and the tax ramifications are reduced. Does this fairly represent the earnings of the company?

However, in selling private companies, it is common procedure to reconstruct or normalize the earnings of a company to attempt to show a prospective buyer the company in the best light. By normalizing the income statement, the "real" earning power of the firm can be shown, which can translate into a higher price. Using a multiple of EBITDA, one can show a company is worth a million dollars more by simply identifying the "add backs" of \$200,000. One way of doing this could be by eliminating any extraordinary items; e.g., non-recurring legal and consulting expenses, a new roof on the plant or tooling for a new product. As Fortune pointed out so vividly: "The cost of things like plant closings and lay-offs is just part of doing business and should count as an operating expense, not as a special one-time charge." Recurring legal expenses, major annual equipment maintenance procedures, etc., are really just part of doing business.

Sellers and their outside advisors should be careful in normalizing the income statements of the companies they are working with - expenses that are just part of doing business should not be added back to create higher profits. It may seem very easy to add back \$100,000 on the premise that a new CEO will be paid \$100,000 less than the current one. Chances are - it won't happen. By the time a new CEO is provided appropriate incentives and generous "perks," there will be no savings.

The moral here is that the reconstructed earnings should not be puffed up to impress a potential buyer. The buyer is no fool - he or she will see right through it all. Some normalization is required and accepted, but excess add-backs will surely come back to bite the seller.

THE VALUE OF A BUSINESS: GET TO THE HEART OF THE MATTER

What is the value of your business? There are many ways to approach that question -- based on complex formulae or just a good hard look at the balance sheet, but no answer based purely on numbers is going to be exactly right. Even factoring in that most popular of abstracts -- goodwill -- the true essence of an operation is not likely to be revealed.

To find the real value of a business, we must go to its very heart: the attitude, work habits, managerial style, customer/marketplace savvy, and community reputation of the person in charge. The business owner or manager is the final, and most cogent, indicator of business worth. Check out the following healthy signs, and then listen to the heartbeat of your own business and its leadership style:

Optimistic Attitude

Many business owners today are more pragmatic and take pride in being less of an "incurable optimist." The owner of yesterday wasn't afraid to follow the words of Willy Loman in *Death of a Salesman*: "A salesman has got to dream, boy. It comes with the territory." A decline in optimism is an unfortunate trend. In a world driven by technology and scientific analysis, it's easy to forget the importance of the right attitude. If business owners aren't positive, how can they expect customers and employers to be? The owner who believes business is bad will probably not see it getting any better. Of course, there are always the real-life factors -- banks that won't lend, customers who stop buying, services that become obsolete. However, if these problems didn't exist, there would be something else to keep the negative thinkers occupied.

How to project a positive attitude? Begin with the easiest. Sprucing up the place of business with fresh paint, newly-cleaned carpeting, well-stocked shelves, for example, will say a lot for the health of a company. Less visible, but highly important, is a positive outlook on the future of the business. Business owners should be prepared to spend what it takes to generate new business, and should take the time to explore new possibilities for long-range success. If the company currently has no mission statement or business plan, creating one will speak volumes about owner's enthusiasm for the future of the operation.

Healthy Managerial Style

In the modern workplace, where you can hardly see the business through the forest of "managers," it's good to get back to basics. Too often owners get bogged down in busy work, or in "managing the managers." They should occasionally take time off to work the floor, drive the delivery truck, sell the product. Owners who put themselves in the trenches are in touch with the business -- and this first-hand understanding will be evident to anyone taking stock of the company's worth.

An equally healthy approach to managing is preparing for contingencies. The owner's style should include appropriate delegation of duties and a backup managerial plan in case of unforeseen calamity.

And finally, owners should project a general sense of well-being and energy. This may be easier said than done, but it's important to note. Anyone taking stock of a business will draw a quick, and key, first impression from the very posture and tone of voice the owner presents.

Customer relations say a lot about the "heart" of a business. The business owner's approach to handling customers sets the standard for everyone down the ladder. A healthy business avoids treating the customer like a number -- or maybe worse, like a stranger. For example, successful big-time operations who deal with customers by telephone make it a point to ask for the proper pronunciation of a name, or request permission to use the customer's first name. Added to basic courtesies is the sense that salespeople are happy to take the time necessary to answer questions and/or deal with problems.

Whether products and services are sold by phone or on the floor, employees should be well-versed experts on whatever they're selling. Again, large outfits have established high standards to emulate; for instance, the outdoor equipment chain with salespeople who can not only fit hiking boots to a T (or a toe), but also know how to clean, weatherproof and care for the leather, vibram, or nylon of which the boots are made. Every hour spent training salespeople in the product pays huge dividends for the company's long-term success.

Conspicuous Image

To foster the image of an on-going, healthy business concern, business owners need to keep their image prominent before the public. Advertising can build image at the same time it attracts business. Anything from a display ad within the yellow pages listings, to a monthly "home-baked" newsletter, to the offering of free seminars, can portray the business as more than just the sum of its products. An example of image-making at its best comes from the owner of a natural foods store in a metrowest Boston town. She not only produces her own monthly newsletter (with product information and coupons, plus general health articles), but she also sponsors evening lectures on subjects such as acupuncture, aromatherapy, women's health, and children's nutrition. What's more, she offers free tours of her in-house cookie "factory" to local schools. The samples the kids take home are the best cost-per-inch ad value imaginable!

For the less adventurous, there are plenty of conservative ways to make ads pay. Every Saturday for years, the sports section of a Los Angeles newspaper carried a one-inch ad for the "Best Hamburger in Town." No catchy phrases, no dazzling graphics, but the ad was there -- and there -- and there again. The consistency sold the restaurant's product and its image and eventually, the eatery became a 10 plus chain.

Community Involvement

To further promote the business -- and its owner -- as a rock-solid and permanent part of the local scene, there are opportunities just waiting to be tapped. Taking an active role in the Chamber of Commerce, trade or service associations, and sponsorship of worthy local events is great public relations. In addition to the more traditional public donations -- providing kids' sports team uniforms, taking out ads in yearbooks -- the business can band together to join walkathons, or volunteer to man the phones for public TV or radio fundraisers. Doing "good" makes the business owner and the employees feel good about themselves.

"Feeling good" is a good point at which to conclude our journey to the heart of a business. Dollars and cents will always be important in establishing value, but it's a kind of people-sense that will give the truest reading.

WHAT IS A BUSINESS WORTH?

Many courts and Revenue Authorities have defined fair market value as: "The amount at which property would exchange between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts." You may have to read this several times to get the gist and depth of this definition.

The problem with this definition is that the conditions cited rarely exist in the real world of selling or buying a business. For example, the definition states that the sale of the business cannot be conducted under any duress, and neither the buyer nor the seller can be pushed into the transaction. Such factors as emotion and sentimental value cannot be a part of the sale. Surprisingly, under this definition, no actual sale or purchase has to take place to establish fair market value. That's probably because one could never take place using the definition.

So what does make up the value of a privately-held business? A business consists of tangible and intangible assets. The tangible assets are the most visible and the ones on which buyers too often base a judgment on the value of a business. As factors of value, fixtures, equipment and leasehold improvements are often valued first by the buyer. Well maintained equipment and attractive interior surroundings are the first things a buyer sees when visiting a business for sale. Make no mistake, regardless of what prospective buyers may say, the emotional impact of a physically well-maintained business can be a very positive factor. In addition, it is much easier to finance tangible assets than intangible ones.

However, buyers have to consider what is really behind those well-maintained tangible assets. There are many businesses, especially today, in which physical assets play a very small part in the success of the business. These intangible factors include: the business' reputation with its customer or client base, and within its industry; mailing lists and customer/client lists; quality of product or service; reputation with its vendors and suppliers; strength of the business' technology and other systems; plus many other factors that can add a lot more value to the price of the business than can shiny equipment.

Although the intangible assets listed above cannot be seen, they are certainly an important part of the business - and purchase price. Businesses that don't need expensive fixtures and equipment can, in many cases, be

expanded more quickly and inexpensively because they do not require cash-intensive equipment purchases. Buyers, to their own detriment, do not want to pay the same price for equivalent cash flow for businesses that do not have lots of equipment. They want to buy tangible assets.

Business brokers and intermediaries know how to point out to prospective buyers the advantages of businesses that may not require lots of equipment but have those all-important intangible assets that create steady cash flow. Business owners who have a service or other type of business that does not rely on the heavy use of tangible assets and are considering selling, should talk to their professional business broker/intermediary who can point out the pluses and the hidden assets of the business.