

How Much is Your Business Worth?

By Nevin Sanli

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Determining the value of a business is one of the most complicated and most crucial tasks. The question “How much is your business worth?” is often asked in times of transition and great uncertainty. The decisions taken based on the valuation can have serious consequences.

A business valuation is needed when:

- a partner or shareholder wishes to buy-out other partners or shareholders;
- an individual or a business contemplates a merger, sale or acquisition;
- litigated matters such as shareholder disputes, divorce, and breach of contract require expert witness testimony on business valuation issues;
- estate and gift taxes must be determined upon the death of a shareholder or owner of a business or upon gifting of an interest to family and friends; and
- taking of property by the government causes damages to a business.

Some of the more esoteric business valuation assignments include the valuation of businesses for privatization; the analysis of the potential proceeds, if any, of an initial public offering (IPO); anti-trust litigation; trademark, trade name and patent infringements; the valuation of intangible and stand-alone assets; and relocation impact studies.

Business valuations consist of determining the value today of

a business' future earnings potential and the risks (threats) of those future earnings. One must forecast future earnings and assess risk. Earnings forecasts depend on the industry and the economic outlook for the business' products, current and future competition, projected changes in demand, and the business' capacity to grow in light of its past financial and operational performance. Risk factors include the business' financial condition (profitability, cash flows, and ability to pay debt), management's ability to sustain operations and profitability, market and industry trends and outlook, competitive forces, the economic environment, legal and regulatory issues, and contingent liabilities. Forecasts and risk assessment require in-depth research and analysis, and due diligence. Access to and use of innovative research techniques (telephone surveys, library research, field studies, product sampling and testing, and industry and competitive research) and information technology (on-line databases and the Internet) are imperative. Effective and reliable valuations depend on excellent research and creativity.

There are two primary valuation methodologies:

The First Method is the discounted future earnings method. It calculates the value today (i.e., discounted for time) of the business' earnings in the future. One must forecast revenues, expenses, profits and cash flows. As indicated above, the appraiser must carefully analyze all factors (threats) that can impact a business' capacity to generate future earnings.

Risk assessment is perhaps the most important aspect of the analysis. The discount rate, which is a percentage number usually between 10% to 100%, quantifies risk. Generally, the applicable discount rate correlates directly with yields on publicly available securities such as treasury bills, corporate bonds and shares of publicly held companies. The higher the discount rate the riskier the business.

The Second Method is the comparable or guideline company approach. In this method the appraiser collects data on recent sales of similar companies and calculates the valuation multiples (i.e., price to earnings, price to revenue, price to cash flow, etc.) for each transaction. The data can be the price per share at the date of value of publicly-held stock or the terms of publicly announced mergers and acquisitions. The valuation multiples derived therein inherently represent the financial markets' expectations of future earnings and assessments of risk. The appraiser analyzes the multiples to determine which ones are applicable to the subject company.

The key in this approach is the selection of the comparable or guideline companies. Traditionalists tend to select companies that are in the same industry, the same geographical area and are similar in size. Recent research indicates that it is more

accurate to use companies that exhibit similar financial performance, operate in similar types of niche markets vis-a-vis their respective industries, and have similar business and management philosophies. This more flexible and more fundamental approach can result in the selection of companies that are in different industries, are substantially larger in size and that operate in distant geographical areas. However, the valuation multipliers derived therein are more applicable to the subject company. One must assure that any guideline company used in the final valuation analysis bears some similar behavioral characteristics as those of the subject company.

Once a set of usable guideline companies is selected, the appraiser must adjust the financial statements of these companies for extraordinary and non-recurring items and for differences in accounting practice. In addition, further due diligence analyses must be performed in order to confirm behavioral characteristics. Some of the limitations of this method are that it is extremely time consuming and is usually best suited for businesses with annual sales exceeding \$20 million.

When economically feasible, the appraiser should use both methods independently. This should yield two values. If the values are significantly apart, the appraiser should reevaluate the methodologies, assumptions and data for each method. However, if upon reevaluation the methods cannot be reconciled, the appraiser must provide an explanation of the divergence and the level of confidence in the opinion of value, if any. In the event that both methods yield similar values, the appraiser must ascertain that it is not due to coincidence and that the resulting opinion of value is robust. Under all circumstances, the appraiser should have a high level of confidence in the opinion of value.

It is prudent to perform a sanity or reasonableness procedure to assure that the business' future cash flows will cover: 1) the cost of financing the purchase of the business at the stated opinion of value; and 2) the projected capital expenditures necessary to sustain operations and growth.

When a business has been losing money for several years and should perhaps be closed, the methods above are not applicable. Instead, one must conduct a liquidation (orderly or fire-sale) appraisal of the business' tangible assets which include real estate, machinery and equipment and inventory. It is preferable to retain qualified specialists in each of the categories of tangible assets.

With some businesses, a liquidation may also involve the separate valuation of intangible assets such as patents, customer lists, trademarks, mail-order catalogues, leasehold

interests, proprietary systems and know-how, royalties, film and record libraries, contracts, and securities (stocks and bonds). These types of assets usually have stand-alone value and should be valued under the assumption that they are not affected by the business' misfortunes. A variety of valuation methods which consider future earnings potential are used for stand-alone assets. Note that going concern businesses also own stand-alone assets which must be valued on a regular basis.

Small businesses, such as restaurants, liquor stores and dry cleaners, often employ a variety of other methods and formulas. Typically, these methods are rules-of-thumb and cannot be supported by sound theoretical foundation. However small a business may be, it is important that valuation methodologies that can withstand the scrutiny of a third party, such as the IRS , are used.

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Nevin Sanli is President and Co-Founder of Sanli Pastore & Hill, Inc. Mr. Sanli, an Accredited Senior Appraiser (ASA), Business Valuation Discipline, of the American Society of Appraisers, and has valued over 1,000 businesses during his career. He specializes in providing expert witness testimony in litigated cases involving business valuation, and frequently speaks on business valuation to professional organizations. Mr. Sanli earned a Bachelors in Honors Economics from the University of California at Irvine. Mr. Sanli can be reached at (310) 571-3400 or <mailto:nsanli@sphvalue.com>

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