

Know Your Company's Value Before Making Plans

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You have been working diligently for several years to build your business and at some point you start wondering: "How much is my business really worth?" You also may be realizing that once you have established the business, its continued success requires you to carefully plan for its future and to pinpoint the factors that will prove vital in increasing its value over time. This, in turn, will allow you to set objectives for your business going forward.

Knowing the value of your business and how to grow it are also important for another reason.



You need to determine whether or not your personal financial objectives will be met when you sell or transfer your business. In fact, studies demonstrate that most business owners have from 65% to 85% of their net worth tied up in their businesses. Thus, since

your business potentially is your most valuable asset, accurately assessing its current value is of critical importance to both your future financial security and your business' financial health.

Reasons why you might need to determine how much your business is worth range from determining a selling price in response to a buyer's inquiry to raising investment capital so that you can expand operations. No less important, valuing your business can provide an important reality check. The valuation will provide a useful snapshot of your business' current situation, the factors that either create or impair its value, what options you have and how the business can be improved over the long-term.

Determining the value of a business is anything but a simple undertaking. In fact, a business may have several different values depending on the purpose of the valuation. Each differ-

ent purpose dictates the valuation guidelines to use. For example, tax and estate planning valuations are controlled by the tax code, IRS pronouncements, and tax court opinions. Valuations undertaken for marital dissolutions are controlled by state laws and family court precedents that vary from state to state. In mergers and acquisitions transactions, potential synergies (i.e. revenue increases or expense reductions) to be realized by the buyer following the transaction will drive the valuation's underlying assumptions.

Thus, the standard of value to use (fair market value, fair value or investment value), the perspective to adopt (owner's, buyer's, or other third party's) and the underlying assumptions (cost of capital, leverage, long-term growth, etc.) will vary depending on the purpose of the valuation.

Valuing a business, therefore, requires expertise and experience. However, if what you want is to determine a preliminary "ballpark figure" of how much your business is worth, there are methods that you can use to arrive at this initial estimation of value. These include such commonly-used rules of thumb as multiples of annual profits, sales or square feet. Every industry has its own set of multiples derived from previous transactions and based on industry-specific metrics (for small businesses, a readily available source for these industry multiples is *Business Reference Guide* published annually by the Business Brokerage Press).

There are two important points to keep in mind when using rules of thumb to determine the value of your business. First, these multiples represent averages from previous transactions in the industry that may or may not reflect the specific conditions (size, growth rate, profitability, etc.), strengths and weaknesses of your business and thus may lead you to the wrong conclusion. Second, as a ballpark estimate, it should be confirmed with proper valuation methods before it is used as a determining factor in decision-making.

When it comes to valuating a business, or any other investment for that matter, two factors drive the determination of worth/value, namely, the benefits to be realized and the risks associated with the creation of those benefits. In a business, the benefits take the form of net cash flows while risk—quantified by an expected rate of return—is a function of the time value of money and the likelihood that the cash flows will be realized. Another important point to consider is that value is a forward-looking concept. It reflects a current assessment of the value of the business' future cash flows (benefits) adjusted by the likelihood that those cash flows actually will be realized (risk).

From this, it should become clear that anything you can do in your strategic planning to increase your business' earnings (revenues less expenses) or reduce the uncertainty associated with those earnings definitely will increase the value of your business.

For example, increasing the number of customers, the size and frequency of their purchases, implementing cost saving measures and introducing products/services that generate recurring rather than one-time revenues very likely will increase business value. In contrast, customer concentration, potential litigation, unstable revenues or profits and poor quality most likely will impair business value by impacting the quantity and stability of expected future cash flows. These are but some of a business' so-called "value and risk drivers."

It is virtually impossible to address properly in a short article the intricacies of determining the value of a business. Business valuation is a process that requires a high level expertise and experience. As such, you should rely only on a credentialed and experienced professional to conduct a valuation of your business. Bear in mind that your company will have different values depending on the purpose of the valuation and that these values change over time—even if the company remains basically the same.

Every business will have different value indications resulting from: the selected purpose of the valuation (tax & estate planning, divorce, mergers & acquisitions, etc.), valuation methods used (assets, income, market-based), or the nature of the interest being valued (control or partial ownership).

Regardless, estimating a preliminary indication of value and beginning to take specific actions immediately to enhance that value will serve to safeguard your financial security and your business' financial health.

About the Author: Enrique C. Brito is a partner and senior managing director of The Mclean Group, a national investment bank providing merger and acquisition, valuation and private equity financing services. He has over 17 years of corporate finance and investment banking experience and lectures nationally on the subjects of M&A and business valuation. He can be reached via e-mail at ebrito@mcleanllc.com or call 703-827-5093.