Chapter 1

The Value of Understanding Business Valuation

In This Chapter

- Why the price of a business is only half the story
- The importance of planning in valuation
- Basic due diligence
- Why families are so important in the process

You're here for one of two big reasons: You have a business that you want to sell, or you want to buy a business. Very likely, the business in question is a small business (with less than $3 million in annual sales), and it may be the first and only business you ever own.

Before we go further, we want to pay you a compliment. Right now, you're doing something that painfully few entrepreneurs do: thinking about what a company is actually worth before you make a major decision or take a major action. You're already ahead of the game. And because you're reading this book, you obviously know that business valuation is an important part of that game.

Business Valuation For Dummies is for people who want to understand value. This book can help you get your arms around the many tasks and variables involved in effective valuation of a company and help you decide what kind of help you should enlist to complete a deal. In this chapter, we discuss the importance of valuation, talk about doing research and calculating value, and include some notes on valuation experts and intellectual property. We wrap up with a discussion of passing a family business from one generation to the next.

Basic Tenets and the Importance of Valuation for Businesspeople

Everything has a value. Putting value in dollar terms is the cornerstone not only of running a business but also of investing in almost any form. Knowing how to arrive at a value for the physical and intrinsic characteristics of a business is essential to building wealth of all kinds.

To that end, people who invest in companies need to look beyond the current state of the business they own (or want to own) and consider what decisions they need to make to boost value. People who have experience in those industries are often best equipped to make those decisions, but it often helps to engage a business valuation expert for guidance. In this section, we discuss the concept of value and note some of the main principles of business valuation.

Value differs from price

As the celebrated investor Warren Buffett once said, "Price is what you pay. Value is what you get." We would add one more line: "If you do your homework."

In business deals, most buyers and sellers have a singular focus on price — and price is hard to avoid. Negotiations ideally produce numbers that both sides can be happy with. But getting to the right price in any deal involves understanding what business assets are truly worth and then structuring a deal around financing and tax realities, which can be quite surprising to those who fail to plan.

Planning drives value

Creating value is a transformative topic in business planning and execution. If you're creating a product, granted, that product is the focus of the business for customers and your employees. Creating *value* — long-term growth in asset value in a company you've built — is something you need to focus on, because a company is the sum of real and tangible assets, investments, ideas, and management talent.

If you can look at all those working parts of a business through the prism of value, the desire to determine and create value in a company can become a much more important driving force in its growth than simple profits and losses.

Proper valuation takes time. People buy and sell businesses for a variety of reasons that aren't all about business. For instance, they may make moves in and out of companies based on career goals. Others devote a lifetime to a business so they can finance their retirement or simply pass the business on to their kids as a legacy. All these motivations drive valuation and should require three to five years to account for owners' estate, succession, and exit planning. We talk about the importance of planning throughout this book.

One of the best places to start finding out about the planning process for starting a business is the U.S. Small Business Administration's Web site (`www.sba.gov`).

No two valuations are exactly alike

No two businesses are exactly alike; neither are the goals and circumstances of business owners. You may be in any of a variety of situations, such as the following:

- You may be the child of a company founder, wondering whether you want to take over the company when she retires.
- You may be a corporate executive who's ready to start a new career with a new business purchased with a cash buyout.
- You may be a worried sibling trying to figure out what to do with the family company because the company's founder, your father, has died suddenly.

Valuation isn't an exact science for another reason as well: The risk inherent in any business situation is far from static. Depending on the economy and the state of the industry the business operates in, the company may be under tremendous pressure to stay afloat, or it may have great opportunities for growth. Any time the economy goes through a major convulsion, people take a fresh look at what value means and at the realities of any deal. As we write this book, the nation is in the grip of a worldwide credit crisis — an economic slowdown that is redefining the values of a host of assets, from companies to private homes.

All these variables are one reason you won't emerge from this book with the skills to do a top-to-bottom business valuation. Also, proper business valuation takes a lot of practice. People with finance degrees and long experience in accounting or other numbers-related fields aren't always naturals at valuation, either. Don't worry, though. This book does cover the ins and outs of business valuation and points out the areas in which you can handle valuation on your own — and those for which you should hire some help.

Valuation isn't a one-time deal

TIP

If you're already operating a business to its fullest potential, valuation isn't something you should put off until you're ready to sell or close your doors. Most tax, business, and personal finance experts say that even if you're years away from retirement — or years away from your next business idea — keeping your valuation numbers current is a good idea. This way, you can make changes and investments in the business so you can leave the business with the highest valuation possible.

A strategy of continual valuation tells you the following things:

- Whether selling your business or merging with another makes sense
- Whether you can make enough money from the sale of a business to support your retirement
- When you want to set a timetable for your kids or other family members to take over the business
- The optimal time to set up an employee stock ownership plan (ESOP) as a way to pull money out of the business in a tax-advantaged way

How often should you run valuation numbers? Frankly, it varies based on need. With computerization, it's easy for many businesses to program their numbers so they can keep a constant eye on their main value indicators that have been developed for any goal they have on their radar.

TIP

If you're working with a business or tax planner, discuss the creation of a valuation system for your business, whether it's something you access yourself or have an expert handle at regular intervals.

Seeing what the finished product looks like is a good starting point, so flip to Chapter 6 for a description of a typical valuation report.

The Basic Building Blocks for Calculating Value

The three top associations for valuation professionals are the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA). These organizations agree on three major approaches to business valuation:

- **The asset approach:** Also known as the *cost approach,* this valuation approach is based on finding the fair market value of assets (the easiest ones to value are tangible assets) and deducting the liabilities to determine the net asset value or the net worth of the business.
- **The market approach:** This approach compares your company or a target company with similar companies. You can use comparisons to publicly traded companies or actual sales transactions for similar businesses. These valuations are frequently expressed in ratio form.
- **The income approach:** This approach focuses on the future economic benefits you're anticipating from a business — better known as income. This amount is expressed in today's dollars, and is also known as *present value.*

For more information on these three approaches, see Chapter 4. In this section, we discuss some of the basic ideas that go into calculating value.

Discount and capitalization rates: The numbers that really matter

Most of the number crunching that goes into valuation doesn't take on real meaning until appropriate discount and capitalization rates are assigned to the valuation itself. These computations allow valuation to become much more meaningful in light of the business the company is in and the various attributes to its industry. We discuss these concepts in Chapter 6.

Doing your homework: Due diligence

The term *due diligence* means investigating a company with the cold eye that you should bring to any investment. For anyone doing the job, due diligence involves reading everything, asking plenty of questions inside and outside an organization, and generally leaving no stone unturned in finding out what makes a company tick and how much it's truly worth.

Due diligence involves not only basic research and calculations, but also the ability to forecast how a company will do years from now.

Whether you're a buyer (see Chapter 16) or a seller (see Chapter 12) — whether or not you're enlisting help with a transaction — due diligence starts with your intentions toward any company. Both soft and hard skills are involved in valuing a business correctly, and in the chapters in Part I, we talk a great deal about the early stages of company research and what you can do to inform yourself about the worth of the business, even if you've never been in business before.

How rule of thumb enters into business valuation

Rule of thumb is a starting point for civilians in valuation — a way to get a general idea of what companies in certain industries are worth. The rest, you have to investigate thoroughly on your own and with the right help. But here are some key points concerning what you're about to see.

Tom West is a founder, past president, and former executive director of the International Business Brokers Association (IBBA). For the past 18 years, he's been the author of *The Business Reference Guide*, an annual bible on pricing for hundreds of categories of independent businesses and name-brand franchises. In Chapter 9, we feature rule-of-thumb guidance for ten kinds of businesses from data West has compiled for the *BRG* and listings on his subscription Web site, Business Brokerage Press (`www.bbpinc.com`).

In West's guide, rule-of-thumb guidance comes in two formats that most valuation experts recognize:

- **Percentage of annual sales:** If a business had total sales of $100,000 last year and the multiple for that business was 40 percent of annual sales, the price based on that particular rule of thumb would be $40,000.
- **Multiple of earnings:** An earnings multiplier makes the most sense to prospective buyers. It directly addresses the buyer's motive to make money: to achieve a return on investment.

  In many small companies, this multiple is commonly used against what is known as *seller's discretionary earnings* (SDE), which are earnings before accounting for the following items:

  - Income taxes
  - Nonrecurring income and expenses
  - Nonoperating income and expenses
  - Depreciating an amortization
  - Interest expense or income
  - Owner's total compensation for one owner/operator after adjusting the total compensation of all owners to market value

Chapter 9 gives you more details on how rule-of-thumb guidance applies in specific business situations.

Getting Expert Help

The authors of this book share a very precise bias: We believe that no one should attempt this process alone unless he or she has been trained and licensed to value companies, plain and simple. It's a very good idea to enlist help wherever you're in the valuation process. Valuation experts can help a business owner locate key benchmark data and other information that shows the worth of companies demonstrating the best practices and best performance in an industry.

Valuation experts (the best ones, anyway) aren't generalists. They do have general skills in finance that allow them to make mathematical calculations — known as *tests* — that are relevant to finding what particular assets are worth. But certain valuation professionals specialize in specific industries and deals. Some work with manufacturing assets, for example, whereas others work with intellectual property; others handle mergers and acquisitions for companies of a particular size.

The various experts in the valuation process include the following:

- Appraisers and valuation experts
- Accountants and forensic accountants
- Attorneys
- Business brokers

We provide a few case studies in this book (especially in Chapters 13 and 18) that illustrate what we believe to be true: Owners lie (intentionally or unintentionally) about their results, and not every business owner is equipped to see through such obfuscation. Even in fairly small deals, much opportunity exists for assets to be overvalued or hidden.

Plenty of business owners resist getting help with valuation because that help costs money. But unless you have significant experience in business or in valuation finance, getting someone who can help you confirm that the asset value of that business is real is a good idea. We encourage you to ask people who work in business valuation plenty of questions, because you need to know that these people understand what you need to value and for what purpose.

You can find detailed books on business negotiation, but unless you can match valuation knowledge with the process of negotiating for the business itself, you may not be fully prepared to make or receive an offer by yourself. In Chapters 13 and 18, we offer case studies that show how buyers and sellers go through the process of valuation. In Chapter 18, we also talk about how mistakes in valuation can damage a deal.

The Move toward Intangible Asset Valuation

Perhaps the greatest philosophical debate going on in the valuation industry is how to place a value on companies that derive most of their asset value from intellectual property. We talk about that debate in some depth in Chapter 5.

Some people argue that old formulas and approaches to valuation have been blown out of the water by the transition to a world that's overrun by Internet-driven companies that outsource much of the production of things you can touch. We don't. Our position is that whether a company's most valuable assets are sitting on the shop floor or inside the minds of some really smart people, those assets need to produce one thing to prove value: profit.

Today, as before, the central identity of an asset is its capability to generate a return. Yet businesses that deal in intellectual property — everything from old-line medical practices to cutting-edge software — need to keep their eye on the production of real earnings.

Family Businesses: Important Valuation Targets

We spend a lot of time throughout this book talking about families because they control the lion's share of business wealth in the U.S.

In 2004, *Insurance Journal* estimated that approximately $40.6 trillion will change hands by 2052, as Baby Boomers pass their accumulated assets on to their heirs. A portion of that wealth transfer will be due to the deaths or retirements of the owners of closely held or family businesses. Yet according to a 2006 report in *Business Week,* the oldest Boomers aren't so willing to die in the saddle. Many owners in their 50s and 60s are willing to move aside after they've made enough money to retire and possibly start new careers.

Many founders or previous-generation leaders are seeing retirement as a chance for new possibilities, so they're willing to get out of the way of the next generation. But are they willing to plan for the smooth transition to the next generation, with clear leadership roles defined and wealth-management issues settled before they go? Not so much. According to a 2003 Raymond

Institute/MassMutual survey, 19 percent of family-business participants hadn't completed any estate planning other than writing a will, and only 37 percent had written a strategic plan for their companies.

Working with family members from the time they're young to gauge their interest and involvement in the business will be crucial to valuation later on. Enthusiastic and talented employees who just happen to be relatives tend to be much more dedicated to growing the company than those who use the family business as a fallback employer. Family members who know where they stand as participants or nonparticipants in the family business are likelier to pull together and do what's best for the business as transitions occur.