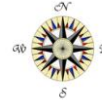


Cumby, Spencer & Associates Financial Group
Guiding your financial path

GUIDEPOST

Business Valuation Concepts

Prepared for
Cumby, Spencer & Associates

Business Valuation Concepts

Business valuation is an important, yet complex process that is frequently employed in a variety of business contexts. It is generally necessary to ascertain the value of a business when: selling to a third party, gifting interests to related parties, obtaining business financing, establishing a value for estate tax purposes, or establishing a value for purposes of a buy-sell agreement. Valuation is a specialty occupation, often practiced by certified specialists and experts familiar with valuation standards, concepts, industry metrics, financial principles, and additional relevant factors and variables.

Standards of Value

There are generally three standards a business valuation could be based upon: fair market value, fair value, and investment value. The purpose of the valuation determines the standard to be used.

- **Fair market value** is to be used in all instances where a business is valued for estate tax purposes. The value of the entity is based on a price that would be reached in a transaction between a hypothetical buyer and seller in an arm's-length transaction.
- **Fair value** arises in instances where business owners seek a resolution for damages they incur from actions taken by the management of a company. When utilizing fair value, the value of a company is determined at a point in time immediately preceding the action that resulted in the erosion of the company's value.
- **Investment value** is a value that is determined between specific parties to the transaction, rather than hypothetical parties. The analyst considers the proposed use of the business by the acquirers, their potential economic benefit stream, and their required rate of return in determining a value.

Approaches to Valuation

There are generally three approaches to business valuation: the asset, market, and income approaches. Each of these approaches has several methodologies that can be used to determine a value. The approach and methodology relied upon depends on the purpose and circumstances surrounding the valuation.

- The **asset approach** is the easiest to understand. Adjusted book value is used in cases where the fair value of assets is deemed representative of a company's value.
- With the **market approach**, a value is determined by using pricing multiples available from publicly traded companies, or recently published private transactions of companies which are similar in nature to the company being valued, to determine a value. Some of the more widely used multiples include Price to Earnings (P/E), Price to Sales (P/S), and Enterprise Value to Earnings before Interest, Taxes, Depreciation, and Amortization (EV/EBITDA).
- The **income approach** derives a company's value either from capitalizing or discounting the projected economic benefit stream for that company. Generally, the capitalization of earnings method is used when a company's projected future earnings are expected to be stable. The process involves forecasting a plausible economic benefit stream of a company given the facts surrounding the valuation. The discounted cash flow method is used primarily when a justifiable forecast of a company's economic benefit stream is available to the analyst, and when the forecasted earnings entail an abnormal period of growth or decline over an identifiable time span, which may be three to five years into the future.

Determining the Capitalization and Discount Rates

Cost of Capital

The cost of capital, also called the expected or required rate of return or the discount rate, is comprised of the cost of equity and the cost of debt. The cost of capital can be viewed from three different perspectives. The first perspective is that the cost of capital is the required rate of return an investor would require from an investment in a company's equity and debt. The second perspective is that the cost of capital is the discount rate used to reach a present value of future cash flows. From a third perspective of a company, it is the return required to attract and retain capital in a competitive environment, where investors consider all possible best uses for their money.

Cost of Equity

The cost of equity can be calculated using the capital asset pricing model or the Ibbotson build-up method. When dealing with larger businesses that are comparable to public companies, the capital asset pricing model is more widely used, however, the Ibbotson build-up method is more common with smaller businesses. In determining the cost of equity using the Ibbotson build-up method, the return on an asset is estimated using an approach where a risk-free rate and other risk premiums are added to determine an appropriate return based on a specific risk an investor assumes.

Understanding the Ibbotson Build-Up Method

- Currently, historical returns for 30-year Treasury bonds are used to determine a riskless rate of return for an asset.
- The equity risk premium is the additional return an investor would require for accepting the additional risk associated with investing in equities as opposed to investing in riskless assets.
- An industry risk premium is typically included when determining the cost of equity. The industry risk premium accounts for risks specific to a certain industry and can vary based on factors such as the industry's reliance on the overall health of the economy.
- A small size or stock premium may be added to the cost of equity to account for the inherent risk associated with small company stocks. For example, for entities valued at less than $50 million, a valuation reduction of approximately 5% is commonplace.
- A company specific premium may be added to account for other risks specifically related to the company, such as management depth, importance of key personnel, stability of industry, diversification of product line, customer base, suppliers, geographic location, stability of earnings, earnings margins and financial structure.

Cost of Debt

To calculate the cost of capital, the cost of debt will also need to be determined. The cost of debt can be determined by using a credit rating agency's interest rates and assuming a specific rating for the company, calculating a weighted cost of debt using the company's actual interest rates, or by using the interest expense and interest-bearing debt to calculate the average interest rate.

Discounts

There are several types of discounts that could be applied to a valuation of a business. Two discounts, discount for lack of control and discount for lack of marketability, are the most often applied discounts. The discount for lack of control accounts for the ability of an owner to dictate the uses of capital and economic benefit stream of the company. The less control an owner has over the sources and uses of capital the less attractive the investment becomes, which would warrant a larger discount on value. The discount for lack of marketability accounts for how active the market is for a business owner to sell his/ her business interests. A business' size, its industry, its quality of accounting and internal controls, and other factors weigh in determining any discount for lack of marketability. The two discounts are not added together. First, any discount for lack of control is applied to the asset's value and then the discount for lack of marketability is applied to the adjusted value.

Positioning the Company for Sale

Maintaining Good Accounting Practices

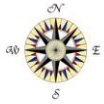
A primary concern of potential acquirers is the quality of the financial statements of the target company. A company's financial statements tell its story to the reader. If the story is not to be believed, the risk to any potential acquirer may be too great to make an offer, or, if made, the offer may be less than otherwise would be made to account for the perceived risk.

Maximize Goodwill

Goodwill is what drives a company's value above the fair market value of its assets. The fair market value of tangible assets provides a base by which a company may be valued. How those assets are utilized to generate cash flow accruing to the equity holders is what generates goodwill. Goodwill can be thought of as return that exceeds the opportunity costs associated with the assets.

Methods to Increase Goodwill

- Over time, good business practices promote recurring business. Recurring business is what generates goodwill. Customers come to rely on the business to be fair in its dealings and its ability to provide a quality product or service. As customers' comfort level in dealing with a business increases, the perceived risk of doing business with a company lessens and the risk of a valued customer switching to a competitor is reduced, promoting the value of the company's name.
- There is a direct relationship between a company's value and the number of customers it serves. A large customer base diversifies the risk of losing business among many, lessening the risk of investing in the company. The loss of one customer among many customers will not have as drastic of an effect on the ongoing success of the company. As the customer list grows, the company has ever increasing control over pricing and margins, increasing the value of the company.
- Companies that are in a high growth phase have enormous cash flow requirements to support increasing working and fixed capital needs. A company can grow only as fast as its internal returns and its ability to borrow will allow. A balance needs to be struck between internal and external sources of financing. If a company does not borrow enough, it will not adequately seize its profit opportunities. If a company borrows too much, it risks not being able to meet its periodic debt service requirements. It is necessary to carefully monitor the company's liquidity ratios (current and quick ratios, accounts receivable turnover, inventory turnover, etc.), its leverage ratios (debt to equity, debt to assets), its coverage ratios (times interest earned), and its operating ratios (fixed asset turnover) to assure its ongoing success.
- Having a stable management team and skilled technicians who will remain with the company when sold can ensure the buyer that the business will continue as usual, customer relationships will be maintained, the reputation of the company will remain intact, the rank and file employees will remain in place, vendors and lenders will feel secure, and the company will continue to grow and the projected future cash flows are attainable. Identifying key employees and implementing a retention plan to assure they remain with the company is often crucial in maximizing a business' value to a potential purchaser.



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Bruce Cumby is the President of Cumby, Spencer & Associates Financial Group. For more than 35 years, he has developed a niche for working with pre- and post-retirement Baby Boomer and business owner clients. Bruce specializes in designing comprehensive, holistic solutions for his client's retirement planning, estate planning, wealth management, and business succession needs, as well as executive and employee compensation and benefits. He focuses on clarifying his clients' goals while creating a road map for their success. He attended St. Joseph's University and earned a Master of Science in Financial Services from the American College.

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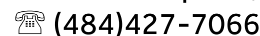
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