WHAT YOU NEED TO KNOW (ABOUT VALUE) IF YOU ARE CONSIDERING SELLING YOUR BUSINESS.

MAXIMIZING THE VALUE OF YOUR BUSINESS

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1 Introduction

The selling of a small or midsize business for premium value can be a daunting task. Understanding the process and dynamics can make it less daunting. Thinking through it all, early on, before you put the for sale sign up. Working in advance, to be sure your organization shines, can make the transfer of ownership for a premium, less daunting and even quite rewarding.

What makes the process unique is the strong relationship between time and information. We have all heard the phrase "time is money" – any successful M&A specialist will tell you that "the quicker I can understand the opportunity, the more likelihood I will uncover the value". Typically, business owners, who spend their whole careers painting a less favorable picture to show the IRS and competitors, are uncomfortable or culturally challenged to tell the whole truth, and not the limited spin that they want others to know. Business owners typically can present their products or services easier and more comfortably than they can their businesses. They fail to realize that professional buyers don't always focus on what the business has done, but what the business can become. Buyers want to understand the past, but they buy the future.

This paper will focus on how to get your business ready for sale at its maximum value. Giving good businesses away is easy, getting its true worth is difficult, but getting a premium price for a business requires skills that business owners can learn. Not learning them can be the most expensive lesson of their lives.

There has never been a buyer who pays a premium for a business that they feel, as the new owner, they couldn't manage better than the existing owner.

2 What a buyer is looking for in a business.

Because profitability is generally the by-product of a successful business, profitability alone doesn't make a successful business. It is the underlying factors that make the company profitable and just as important is the ability for the company to continue in a profitable, growing mode after a sale takes place. Buying a business is a risky venture and investors are generally averse to risk. Many businesses go bankrupt because companies don't always attain the same profitability after a change of ownership has occurred. Buyers often wonder why the "cash cow" they thought they bought turns into a "white elephant".

A successful business is made up of a combination of the following factors and not in any particular order:

2(a) Good product or service

Sales and marketing gets the product or service in the door at least once, but it is the perception of a good product or service that keeps people coming back. It is the repeat business that creates the base to grow the revenues. A business that has to find new customers to replace lost customers is not one that lends itself to high goodwill value unless the new customers are finding their way to the business via company or firm(not personal) reputation.

2 (b) Strong marketing plan

In that same vain, a good product doesn't get sold just because it is good. The term "if you build it they will come" may have been good for a ballpark in the movies, but if a good product or service isn't marketed properly it will not achieve its potential. Our favorite comparison is Microsoft and Apple in the 1990's. Apple's operating system was said to be the best, yet through good (possibly unfair) marketing Microsoft has dominated the market on almost all desktop computers. (PS. Apple got their revenge through creating breakthrough personal technology, now far exceeding Microsoft's market value)

2(c) Key people/Management Depth

Small, successful companies where the owner wears all the significant hats that drive the revenues and the profits may be considered too high a risk. The ideal structure would be to have several key people that will remain after a sale takes place. Many times in a smaller business it is the chief salesman who is the key person next to the owner and he/she needs to be part of the transition process if not part of the new ownership. Savvy due diligence by the buyer will ferret out whether the business is overly dependent on the exiting owner and whether the exiting owner's relationships can be transitioned.

2(d)-Customer Dependence

The risk in a business model is drastically curtailed if the company has a significant number of customers or clientele with none making up a significant percentage of revenues. Perhaps the highest risk in any business is the continuity of the customer base after a change in ownership. With personal service businesses, business continuity is most threatened when there is a change in management. It is less risky where there is a specific product sold unless the mode of sale and prices change right after the sale.

Sometimes a few large high profile customers are fine with a buyer that already has an existing business and needs to penetrate another company's customers with their own products. This is known as synergy.

For example, supposing there is a computer service company and greater than 50% of its revenues are derived from two Fortune 500 customers. This company may be a good acquisition target of a software company that targets businesses such as these large customers and what better way to get in the door than buying a company with the needed clientele. Sellers though, with a high dependency on a small number of clients can still sell businesses, but the purchase price and payments will generally have more contingencies over a more extended timeframe.

2(e)-Proprietary Content/ Intellectual Property

The unique quality of the products or services offered is one aspect of where a valuation premium can be manifested. Products that are unique, protected from copying and have a significant market and growth potential or an unexploited use may allow for a value that is beyond normal business valuation models.

2(f)-Profitability

For “brick and mortar” businesses, profitability is key. A strong gross margin is many times more important than the bottom line profitability because in many businesses that is an area that cannot be changed. Administrative overhead can more easily be altered with better management than the gross profit can be.

We had a situation where the owner was doing so many tasks and running so lean that the profit was three times that of the norm in the industry. In that case it was difficult to find a buyer to pay the normal multiple of income because the buyers felt they could not be as efficient as the current owner and would have to pay three salaries to make up for his one. That is an unusual and extreme example. More often than not, buyers would want a “lean and mean” operation.

On the other hand a company that is run too frugally may not have made an investment in the future of the company. The current owners accounting systems may be outdated, the factory and the facility may have been run down and not maintained. Informed buyers will be looking closely at these items.

We will discuss later how the income statement is adjusted.

2(g)- Employee Turnover and Employee Relations

It is more comforting to a buyer that the target company has low employee turnover- especially in the service businesses. Again, an investment buyer is looking to step into the shoes of the existing owner in a seamless fashion. Having a strong falloff of staff after an ownership change will likely be detrimental to the new owner.

A potential buyer will have to be comfortable that the employees aren’t too tied to the owner in friendship. This would be especially true in an industry that competes for the same workers. Many employees stay with an owner because they are treated well. A buyer cannot expect to replace the ownership easily if such is the case.

2(h)-Management Information Systems

“Good Books and Records”- Often this is the part of a business that is ignored by the owner. They figure they are making money and who cares, other than the IRS, what the details are. However, a buyer cares. A buyer wants to know what products are selling, who they are being sold to, trends in sales, cost of sales by product line, etc. They also need to easily prove all the representations made by management and their Merger and Acquisition advisors. **We have seen many deals never get off the ground due to inadequate information and accounting systems**.

2(i)-Accounts Receivable and Inventory Turnover

Cash flow either current or future is one of the main drivers in valuation. A business can sell its products all it wants to but if it is overstocking or not moving the inventory and not collecting receivables timely, this means that the investment in working capital is significant and the ability to turn profits into cash comes too slowly-hence diminished value. A company that manages its

collections and manages its inventory in an efficient manner is very attractive to a buyer if that is coupled with profitability.

3 Preparing the Business for Sale - The Confidential Business Memorandum and the SWOT Analysis (Strengths, Weaknesses, Opportunities and Threats).

One of the best ways to successfully sell a business is to plan ahead by writing a confidential business memorandum (CBM) and preparing an honest analysis of the strengths, weaknesses, opportunities and threats (SWOT) of the business.

The SWOT analysis is the buzzword of many companies that are evaluating their business models. We have found it extraordinarily useful when interviewing a business owner because almost always they hadn't thought about half of the SWOT categories. They are generally amazed when the interview is complete of how much they hadn't realized what a potential buyer may come up with to negotiate a lower price for a business.

The SWOT analysis is part and parcel of a CBM meaning that it is included in the CBM as well as a business plan but may be written and analyzed before a CBM is drafted or it can be prepared during or after the drafting of a CBM. However, no CBM is complete without the SWOT analysis.

3(a) Drafting a Confidential Business Memorandum

A business plan is a document that describes how an owner feels his/her business could be managed better, while a confidential business memorandum is a document that conveys the opportunity to a potential buyer.

The CBM is written for the owner to identify to a buyer all of the information about the company that a buyer needs to decide to move toward negotiations. This document is similar to a business plan except it is geared towards a sale rather than how to achieve long term growth. Some CBMs are an entire book in length and some are short, maybe 20 to 30 pages complete with graphs, projected and historical financial statements and exhibits. The CBM should be written as though the owners are enticing an outsider to invest in the company yet it should be honest regarding the issues a buyer will be facing but postured in a positive way.

The characteristics of the CBM generally contain the following sections:

Executive Summary

A short description of the business, objectives and projected financial highlights of the company are summarized in this section.

Business Description

A detailed description of the present and anticipated future ownership, a history of the company and key employees and their attributes needs to be included.

Products and Services

A detailed description of the current products/services, their market position, inventory or work in process description and sales by product category- historical and projected. Also included in this section are how the company bills its customers, the accounts receivable collection cycle, means of collection and a detailed description of the manufacturing process or service process and the quality control procedures.

If applicable, a description of research and development being performed and the annual budgets for these, should be included here. If new products are in process, describe what necessary action is needed to get them to market. The research and development can be an entirely separate section of the CBM.

Markets and Customers

If not known through normal trade channels, the market for the product or services should be researched and described. Also, where the company fits into that market either present or future is included.

The customer base should be described and the key customers should be highlighted with sales to each by year historically and projected if possible. A detailed description of how the company has or will further penetrate the market sought and the amount of anticipated monies it will take to accomplish that goal.

Financial Statements

This section includes historical financial statements and projected financial statements as well as profitability ratios and growth statistics. The historical financial statements should include at least five years of data (if available) but can include more, and should be normalized. The projections should be three to five years. A well-prepared realistic financial projection will indicate whether a buyer can afford to implement the business plan on its profits or whether it will need additional working capital to accomplish it.

3(b)The SWOT Analysis

In order for the business to truly be prepared for a sale and realize maximum value, the owner must take the time to identify the existing strengths and weaknesses of the company, as well as, the unexploited opportunities and threats. The SWOT analysis should be an integral part of the CBM whether as its own section or embedded in each section. This is a key tool for both non-selling businesses as well as those that are selling.

Once all the strengths and weaknesses are identified, we work with the company to enhance the strengths and posture the weaknesses.

Any business can create a SWOT analysis. The user should simply identify what the positives and negatives of their organization are currently. “Strengths and Weaknesses” are generally made up of the following categories.

- **Mission and Vision**

Here you want to clearly state the organization's core mission, its passion that drives owners and employees, the organizational rallying point. State also your vision for its direction, that perfect picture of where you see it getting to, as it relates to the mission, not the money. Describe the business vision, fundamental goals or why you are in business. This should be a brief, big picture statement including what you sell and mention the industry in which you compete. It should not exceed 3-4 lines.

- **Strategy**

Your strategy is the how. How are you going to accomplish and how you plan to accomplish all you've laid out in your mission and vision. The strategy section of your plan/descriptive, gives you and the potential buyers a sense of your business direction. It provides focus on the long term goals and action plan. Many business owners feel comfort reading over this section during difficult times or times of change to re-establish a sense of purpose for the business.

- **Organization**

A simple but effective way to lay out the structure of your company is to create an organizational chart with a narrative description. This will prove that you're leaving nothing to chance, you've thought out exactly who is doing what, and there is someone in charge of every function of your company. Nothing will fall through the cracks, and nothing will be done three or four times over. To a potential buyer, that is very important. Laying out the hierarchy, a 'flow chart', the operational basics of work flow and decision making, is a great way to highlight value in your systems and processes, above and beyond competitors.

- **Marketing and Sales**

Some of the questions to consider are whether the organization is able to measure how effective the marketing is. Is the marketing and sales based upon personal relationships that have nothing to do with general marketing and that may not be transitioned to a new owner? Clearly this will be one of the key items of the analysis that will need to be addressed. Is the company reliant on continually bringing in new clients, or is the retention and growth of their existing customer base critical to the success and growth of the company.

- **Innovation and Growth**

For a company that has a product, is the company spending money on improving the product? A strong sign would be that the underlying products or services have evolved with the demands in the industry. A weak sign is that no money is being spent and sales are dwindling because other organizations are more up to date.

Typically we think of innovation as being product oriented – a newer, better widget. However, as the service sector dominates both in the numbers of and in gross sales of small and midsize companies, strengths or weakness in innovation can be in employee training, communication systems, distribution concepts, use of technologies, purchasing systems, and even financial or

financing models. Capturing what constitutes innovation is critical in commanding value in the eyes of a buyer.

- **Human Resources**

Identify in a realistic manner the strengths and weaknesses of the company's personnel. This is generally the key to maintaining value from a buyer's perspective especially when the company is on the larger size of small. Many equity firms will at times pay a healthy premium for business target companies that have over $50 million in revenues because that level of sales is usually not relying on one person, and a company of that size usually has management depth that can be utilized in an ownership transition. For those owners that have smaller businesses, it is important to posture the company as not so dependent on a sole owner. Key people are tantamount to maximizing value.

- **Operations**

The Operations Plan is a key component for most business concerns. This is particularly true for manufacturing and assembly businesses that need to identify uses of technology, production timetables, inventory purchases/management, and labor costs. Service related businesses typically address all of the same issues in the operations plan with a few exceptions; the product for a service business may be intangible such as a knowledge-based business like consulting.

For small businesses, the operation plan primarily focuses upon administration and production.

Operations Plans may include:

- Inventory
- Supplier analysis
- Scheduling
- Production costing (how much does the product or service cost the business)
- Monitoring/benchmarking of key milestone dates
- Distribution
- Human resource requirements

- **Management Information Systems**

There is nothing more frustrating to a potential buyer than trying to extract needed financial information and hearing that it can't be done without consuming a lot of time. If a potential buyer needs to review, for example, the ten largest customers' sales for the last three years by product, a well-run business will generally have this information available quickly via the information systems.

Less than standard financial systems are not uncommon. There are many profitable businesses without them. At times, however, when they fall into hard times and because they have poor systems information they cannot produce valuable information that would help them explain the downturn rather than guessing. For instance we were valuing a company where one year they had a gross profit margin of 27% and on the same sales there was a margin of 32% the next year. It was a $20 million company and they couldn't explain why the margin changed or what

products caused the margin to change. They had to guess rather than look into their accounting system and derive an answer. This lack of data can and will cause a potential buyer to be wary.

- **Finances**

The questions to ask in this category for determining strengths and weaknesses include how is the company doing in relation to its peers, are accounts receivable collected timely, does the company have good credit. A company can have a lot of profit with little cash flow. This is either due to heavy growth with not enough of a credit line, poor collection management or a combination of both.

Many small businesses have stripped all its cash. The potential problem with that is if sales drop and the company falls on hard times, is there a pool of cash to draw from?

- **Products and Services**

Is the business selling a service or product that is becoming outdated and obsolete? Identify what is wrong with the products and how much capital it would take to improve or update.

"Opportunities and Threats" are those items that are more external to the business. They are generally made up of the following categories:

- **Industry**

Know or learn the industry. There may be public companies that you can read about that are in your industry or there are trade organizations that publish industry data. This information is generally easy to find. The most common threats facing any industry are obsolescence from new technology and outdated manufacturing processes. The most common threat to American manufacturing are products being made more cheaply overseas.

Opportunities need to be identified to a buyer such as untapped markets. Your product or service may have only been sold to one sector of the economy but may be applicable to other sectors. Presenting this opportunity may be an opening to realizing a premium for your business to the right buyer.

- **Competition**

Is the business owner even aware that new competition is about to take market share? Lack of competition or describing how competitors are weaker is important to a buyer. How does the subject company keep its edge on its competitors? Again, maybe it is a result of good salesman relationships that are personal to the owner or a key employee.

- **Technology**

This section is at times addressed in the industry opportunities and threats section, but with the proliferation of technology in most industries and businesses, and the reliance on many forms of technology for operations, marketing, and many other key components of a business, it is

suggested to address the important, unique and critical technological issues separately. You do not necessarily need to detail all that is needed and/or used, but a brief on what is needed, what is used, why and if there are other considerations, good or bad, that need to be aired out.

- **Customers**

The highest risk in a business comes from customer/client concentration. Adding to this threat would be that some of the customers are not doing well themselves. Are they beginning to pay their bills slower or are they not able to turn the purchased products over? The perfect example is the US custom plastics manufacturers who generally relied on a few large customers and made much money servicing them over the years. What happened is overseas competition was able to make the same products for sometimes less than ¼ of the price that the US custom shops could. The last ten to fifteen years have been very rough for that sector and the future is not so promising either.

Opportunities with the customer base are likely with the right buyer who offers more products than the selling company and the customer base is likely to expand the buyer's business.

- **Economy**

Although the threats and weaknesses in this category are likely the most generic answers- i.e. "when the economy is good the company does well," the greatest positive spin in this category would be that even when the economy was not doing well the seller's business remained untouched or recession-proof.

Does a poor economy affect the seller's business negatively? Does a good economy effect the seller's business negatively?

- **Political**

Threats in this category do not only stem from the seller relying on government contracts but are there laws and regulations to be that will affect sales. A good example is environmental equipment or engineering companies that rely on strict clean air laws. Easing these restrictions or at least strong discussions of it in the industry can cause a buyer concern.

Once the SWOT analysis is completed, it needs to be analyzed. Even though the weaknesses and threats are generally negative and some may not be able to be tempered, an educated buyer will either know them or find them out. They may find them out after both seller and buyer have spent inordinate amounts of legal fees and personal time only to have the deal change or fall apart. Total honesty, in the first drafting of the SWOT analysis, is the best approach.

4 Recasting the Financial Statements

There are few active closely held businesses that do not have expenses on the financial statements that are either non-recurring or non-operating and are for the benefit of the owners or their families. In other words, it is hidden compensation. The financial statements almost always

need to be adjusted to reflect true owners' income. This chapter is not designed to belabor the tax implications of some of the creative ways owners compensate themselves but rather adjust the financial statements to present them in a more industry normalized and comparative manner.

The recasting of the financial statements or adjusting the tax return income and expense items is one of the most important steps towards determining the value of a company. One cannot determine the value of a low-tech bricks and mortar business without starting with the correct amount of income. The owner needs to think clearly about all of the benefits they are deriving from the business, the costs/expenses that a buyer does not and will not have to incur.

At the end of this exercise we want to be able to determine and calculate growth and other statistics for a three to five year history for the following adjusted numbers:

Earnings Before Income Taxes (EBIT)
After Tax Net Income
After Tax Cash Flow
Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
Owners Income (Income before owners compensation)
Owners Cash Flow (EBITDA before owners compensation)
Adjusted Revenues
Adjusted Gross Profit
Tangible Net Book Value

Some or all of the above categories may be used in the valuation of a company.

Over the years we have seen many different adjustments to expenses and income. The most common are as follows:

A. Excess owners compensation

The owners can pay themselves whatever and however they want- all compensation is initially added back and a fair compensation, one that a company would have to pay a non-owner in the same position, is subtracted.

B. Fair Market Rent

Many times the owners of the business own the facility where the business operates. As such, the rent can be set at any rate much like the salary. The rent has to be adjusted to reflect the rents paid to an unrelated party. Where the business owns the building and no rent is charged, all of the expenses related to the building ownership such as depreciation and landlord required maintenance and repairs are added back to income and fair market rent is subtracted. The value of the real estate net of mortgages is then added to the value of the business operations to yield the value of the entire business.

C. Tax depreciation

The depreciation on a financial statement or a tax return almost always is not at an economic rate. For instance a well-maintained forklift can last 15 years, yet for tax purposes it is

depreciated over 7 years and with bonus tax depreciation another 50 to 100% of the cost could be depreciated. This category of adjustment is most important for capital intensive companies.

D. Personal or Non-Essential Expenses

The most common categories business owners include are payroll for non working family members, personal insurance, automobile expenses, personal telephone and cell phones, home utilities, legal and professional fees, supplies and anything else one can think of.

E. Travel and Entertainment

This is generally the most infamous category of burying personal expenses. It is the main reason why Congress decided to take the sails out of this deduction and only allow 50% of meals and entertainment. Many IRS general audits of businesses concentrate on this deduction.

F. Cash Basis to Accrual Basis Adjustments

There are many profitable service companies that do not prepare annual financial statements and the only statement they have for an outsider to measure their performance is a tax return. There are two basic methods of tax reporting cash basis and accrual basis. The cash method of reporting tax information reflects only cash received (not billed) as income and cash payments made for expenses. The accrual basis of tax reporting reflects income as billed or incurred and expenses as incurred. You can tell the difference by looking at a balance sheet. If trade accounts receivable and accounts payable are present, the company is reporting on an accrual basis. The accrual basis of accounting generally gives the best accounting measure of profits for the business, but cash basis businesses provide the best tax advantage. Many times a fast growing cash basis business's tax return reflects losses because of the timing of expense payments and collections

With some exceptions, service businesses are allowed to be on a cash basis for tax purposes. One of the methods to defer taxes that cash basis businesses use is to delay depositing income checks in the bank prior to the end of the tax year. Unfortunately, this gives the effect of a poor economic performance when in reality the company may be doing very well. This is why working with an experienced merger and acquisition specialist or forensic accountant who knows how to adjust the books to reflect proper economic performance is imperative to getting the business ready for a sale.

The cash basis business owner should keep a schedule of accounts receivable and accounts payable for each year-end in case an accrual financial statement becomes required.

G. Revenues

For accrual basis goods companies, one of the ways a company defers tax revenues is delaying shipping of their products to the next fiscal year. This needs to be adjusted for, since it distorts economic performance.

Once the above is accomplished for a three to five year historical period, the adjusted historical income statements and balance sheet can be used as a basis to prepare a financial projection and/or estimate a value.

H. Mixed Businesses

Some business owners have other businesses in which they run some expenses and income through the books of the business being sold. The adjustment of these types of items makes the buyer concerned. How does the buyer reach a comfort level that all of the income and expenses of the other business has been properly bifurcated? The buyers should be doing their own due diligence. However, the less work the buyer has to do the better, and the quicker a closing can happen. This goes back to the MIS systems in the SWOT analysis. If a business buyer has to fight to get the needed information about the business to make an informed decision, it can be a deal killer.

I. Unreported Income

This topic is one that needs to be strongly considered by the business owner and their advisors. There is a large amount of unreported income or tax fraud in cash businesses in this country and likely many countries with a high rate of tax. It is certainly dangerous to have a second set of books and even if you have one proving this second set of books is correct to a buyer is difficult. Yet in some types of businesses unreported cash income is normal such as a retail store or a wholesaler that sells to retail stores. In these cases, it is likely prudent if a sale is being considered to start recognizing the income on the books for a couple of years before a sale takes place. The less the business owner has to prove to a buyer the better.

J. Non-Recurring Expenses

Any significant expenses that are not a regular event in a company's history are adjusted to reflect comparative ongoing economic performance. A perfect example is excessive legal fees related to a lawsuit that is not expected to recur or be ongoing.

One way the business owner or professional advisor can be ahead of the curve in selling their business is to schedule out on a computer spreadsheet comparative income statements and balance sheets for a three to five year period complete with percentages of income that each expense category represents year to year. Review each expense for comparability both before and after adjusting the numbers for the items in this section.

An example of an adjustment to income schedule may look as follows. This schedule is generally footnoted with explanations

XYZ INC
Schedule of Adjustment To Historical Income

	2013	2012	2011
Unadjusted Pretax Income	$ 435,000	$ 133,000	$ (15,000)
Owners Salaries	700,000	400,000	295,000
Non Employee Payroll	26,000	35,000	18,000
Non Recurring Fees	10,000	30,000	
Owner Perqs	36,000	28,000	40,000
Personal Insurance	6,000	7,500	3,500
Adjusted Owners Income	$ 1,213,000	$ 633,500	$ 341,500

5 Valuing the Business

Valuation is an art and not an exact science. Therefore a valuation conclusion is an estimate of value based on an analysis of numerous factors. The true value of a business is what it ultimately sells for and no appraiser can give a concise valuation. The valuation is simply a market analysis estimate of what the business can or may sell for. The estimate of value assists the seller in assuring the business isn't being sold for less than fair value.

There are dozens of books on how to value a business- some are almost a thousand pages long and some are in multi-volume sets. Therefore, this chapter will only give a brief overview on how a business is valued and will not profess to be authoritative on how the reader's business or their client's business will be valued. We will attempt to explain the process and give an idea within what range certain businesses could expect from a sale.

5(a) What is Being Sold-Assets or Stock

Most appraisals set out to value the stock or ownership units of a business. However, how most small businesses are purchased in current times is by buying their assets. Buyers today do not want to buy the potential skeletons in the closets of small closely held businesses. One can think of the countless problems a corporation could have such as toxic tort issues, various tax exposures, employee discrimination issues and other such time bombs that leave a buyer potentially unprotected after the purchase of corporate stock. The way to assist in alleviating these issues is for a buyer to buy the assets of a business.

Most sellers want their stock purchased because of the tax advantages of capital gains. It is for this reason that most small businesses should operate either as Limited Liability Companies, S Corporations or any other singly taxed "pass-through" entities. This way, it makes it less costly from a tax prospective to sell the assets because most of the gain on the sale of these assets will likely be at capital gain rates.

Hence, it is therefore wise to expect the sale of most small closely held businesses today to be in the form of an asset sale rather than a stock sale.

5(b) Standard of Value

Appraisers value businesses based on the situation that promulgates the valuation assignment For instance, if a company is valued for estate tax purposes, the approach and result may be different from one that is valued based on a divorce or shareholder suit. These types of valuations fall into two general standards, fair market value and fair value.

Although the “fair value” standard in litigation is generally judicially determined, it may yield a greater valuation result than fair market value. Fair market value relates to the price paid between hypothetical willing buyers and willing sellers who are under no compulsion to buy or sell and all facts are disseminated between the parties. Believe it or not this definition was defined by the IRS in Revenue Ruling 59-60 and the definition was so sound and so thorough that it is memorialized and used by almost all appraisers today. Fair value in financial reporting can be significantly different.

However, for this chapter, we are going to discuss valuing the company based on the highest value the company can receive on the open market. Any conclusions drawn are based on who the most likely buyers of the business are. As merger and acquisition specialists our job is to seek out the investor that will pay the highest price for the business. The ultimate result would be to create a bidding war for the business thus yielding the greatest value. However, not every business can be fortunate enough to have greater than one person vying for ownership. Nor is it always a good thing because buyers may overreach just to get in the door and pull back after the fact.

5(c)-Types of Buyers

There are several types of buyers for companies and not all have the same motives for buying. Certain motives can create higher values. The various classes of buyers are as follows:

1. **Job Buyers**

   Individuals are buying a job for themselves because they want to own their own business. Typically they will go to the Small Business Administration for a loan or the seller will have to take back paper. They don’t always have much or enough money and many times can’t handle the business. They often pay more than the business is worth and run the business into failure. Sometimes they are more successful than the original owners, but that is not the norm unless they have worked in the industry.

2. **Investment buyer**

   Here, typically a well educated, industry savvy individual or a group of individuals buy a company to yield a healthy return on their investment. This group may or may not be managing the business and may go out and hire professional management to grow the company. This type of investor will likely not pay the highest premium but is the most common type of investor for smaller middle market businesses (revenues $5 million to $25 million).

3. **Private Equity or Venture Group**

These are "buy out" funds set up to buy and sometimes directly manage businesses. Institutions and high net worth individuals fund these groups. Generally, a Private Equity group will buy a profitable platform company in a certain industry as a vehicle to buy other related industry businesses called add-ons. Savvy, sophisticated individuals that typically deal with larger middle market businesses manage these funds. Revenues range from $25 million to $500 million for profitable platform companies and over $10 million for add-ons. The larger, self-managed companies will yield a premium but only if they have performed the necessary steps as outlined in this chapter. The most important traits to these types of investors are lack of customer dependence, non owner self-management and growth potential. These buyers may require the owner take back some paper or reinvest some of the proceeds and will require earn outs (payments based on future profitability) if the agreed upon sales price is based on aggressive projections.

Some M&A specialists would say there is not much difference between the investment buyer and the private equity groups. Typically Private Equity Groups are better funded and can pay more cash up front than smaller entrepreneurial investment groups.

4. **Synergistic or Strategic Buyers**

These are the buyers that may pay the largest premiums for a business. They are looking for complementary products or add-ons such as described in the platform companies previously or are looking for customers to expand the revenues of their existing product lines. A good example of the synergistic platform buyer in the past 10 years would be Cisco Systems. They had synergistic merger after merger building themselves to the largest market valued company prior to the tech crash of 2000. Companies that were added on in the early 90's where the owners traded Cisco's stock for their stock not only received a big premium up front for their companies but also received a tremendous gain on the stock they received assuming they exited on time. There are many examples of large premiums paid for closely held businesses by synergistic buyers.

The biggest challenge, however, faced by selling to these types of public company buyers where they pay with stock, is most of the times the stock received is restricted from sale basically for 1 year. A buyer has to make an informed decision whether to take less of a premium for a cash buyout.

Synergistic or strategic buyers aren't confined to public companies. Equity group platform companies and other closely held businesses buy other companies as well and generally pay cash and a premium if the company is positioned properly.

5(d) The Valuation Process

The process of valuing a business can be a lengthy one because of all the information that has to be gathered, synthesized and analyzed. One thing is certain, if you have a significantly sized company and you want a premium when you sell your business your management information

systems needs to be up to date. When a buyer asks for financial information the owner needs to provide them with prompt accurate data, otherwise many deals fall apart during due diligence,

We will discuss the processes we perform to value and evaluate a business for sale. The reader will find the process very similar to what has already been discussed previously in this chapter regarding the Confidential Business Memorandum (CBM) therefore those aspects will not be discussed at length.

The first step in valuing a business is getting to know the business. We review marketing materials, web sites and interview the owners with a detailed questionnaire. Many of the questions in this survey are those that are described in the SWOT and CBM section 4.

We then prepare a spreadsheet of comparative financial statements for several years- preferably five years. From this sheet we will ask about all of the compensation items and all other adjustment items as discussed in the recasting the financial statement section 5. We will adjust the financial statements and then compare the adjusted company ratios and other data to other companies in the industry to see if the valuation subject is on par, better or substandard relative to the industry.

The next step is to perform an industry analysis and possibly a geographic area analysis if the area affects the business. There are many service bureau's that perform this analysis and what we usually do is perform the industry research privately and order one from an outside service to corroborate our own research.

Once the company profile, financial statement adjustments and the industry profiles are done we are ready to begin valuing the business.

5(e)- Approaches to Value

There are three basic approaches to value- income approach, market approach and asset/cost approach. The following is a description of each:

Income Approach

This approach is based on the anticipation and return on investment. That is, the value of an investment in a business enterprise is a function of the future benefits and/or returns that will accrue to it. Under this approach, future benefits are converted into present value amounts at an appropriate required rate of return (or discount rate). The discount rate employed in the valuation analysis is expressed at a level commensurate with the underlying risks and uncertainties involved with the ultimate realization of the forecasted return streams.

A prudent investor, interested in the potential return capacity of an investment, would tend to use and rely upon the income approach as a key determinant of value. Under the income approach either historical earnings are used to multiply and yield a value or a projection is prepared and the future earnings are present valued to today's dollars.

The discounted future earnings method is used when the Company's near term future (3 to 5 years) income stream is going to be predictably erratic either upward or downward and then turn steady further into the future.

The single period capitalization of earnings is used when there are neither specific anomalies nor abnormalities anticipated to affect the Company in the near term. The Company's earnings are expected to grow (or diminish) by a steady average rate.

Valuing a business is a complex process but the overall theme can be simply compared to valuing a bond. A bond value is equal to the present value of future interest payments plus the present value of the bond principal paid at the end of the bond term. The businesses valuation premise is not much different

Generally the multiples that are derived from the income approach to value are price to earnings or cash flow either pretax or post tax.

This income approach is the most utilized determinant of valuation. This is because there is little market data available for small closely held businesses or if there is data, the data isn't always reliable.

Market Approach

A market approach to determine value basically involves a comparison of the financial and operating results of the subject with equivalent factors of other companies engaged in similar lines of business for which published data are available, and whose securities are traded on a stock exchange or in the over-the-counter market. Indications of value are then developed by application of certain market multiples such as price/revenue, price/earnings, price/cash flow, and price/book value of the comparative firms to the corresponding revenue, earnings, cash flow, and book value investment parameters of the subject. Since the ratios derived in the analysis are based upon publicly-traded share transactions, the values so indicated under this approach are expressed at an "as-if" freely traded interest level.

There are also closely held business transaction databases available including Mergerstat Transaction Roster, Pratt's Stats, BIZ COMPS, Done Deals and the Institute of Business Appraisers (IBA) to name a few. We will not review the positives and negatives of each but just know they are accessible with a subscription to each.

Generally the multiples of value derived from the market approach would be price to EBIT, price to EBITDA, price to earnings, price to sales and price to owner's income.

The data contained in these databases is good for at least testing the appraisal conclusions from the income approaches. If the business being valued resembles a strong relationship to any or some of the comparable companies in the above databases, then the market approach may be the ultimate determinant of estimated value.

Asset/Cost Approach

The Asset or Cost approach involves consideration of the book value, adjusted book value, or the estimated liquidation value of the company subject to appraisal. Book value (also referred to as *net book value*) is an accounting convention referring to the sum of a given company's assets, expressed at its historical net cost basis, less the face value of all recorded liabilities and debt. There is no theoretical underpinning, conceptual justification, empirical data, or economic reasoning to suggest that the value of a business enterprise (under any selected standard of value, such as market value) would equal a firm's historical cost-based book value. Hence, book value is not usually related to any concept of economic value, except where value is defined as a multiple of book value.

The adjusted book value (or net asset value) approach, as the name implies, utilizes the most current balance sheet to the valuation date and attempts to substitute market values for stated book values. This

usually involves a detailed, itemized appraisal of all of the subject company's assets, as well as a review of all outstanding interest-bearing debt in order to determine market value adjustments to apply to historical net book values. It is noted however, that the adjusted book value methodology bears little significance to a common stock investor, since it is independent of a firm's prospective return power. In addition, it does not reflect any intangible elements of value such as goodwill or going concern, which can be of significant magnitude in profitable service type companies.

Hence this valuation method is used the least for companies that have strong evidence that goodwill or other intangible values exist.

6. Cutting to the Chase- Business Brokers Approach to Estimating the Value of a Business

Business owners come up to me and ask how they can better understand the process of and conclusions drawn in the valuation of a business. There are many articles that have been written on the subject of valuation and still many people seek clarification. This is understandable since traditional valuation methods are very technical and confusing to the layperson; however the complexity is necessary because of where appraisers get their data from and the way they are properly taught to apply it. Many authors try to simplify the explanations but still have difficulty because the traditional methods of appraisal are complex but albeit necessary.

Quite frankly I see the same issues- I can explain valuation to some people and they get it, and some people continue to have difficulty understanding it. Does a person really have to be mathematically oriented to understand the simplest aspects of the valuation? I would like to believe they do not. In this article, however, I am going to approach the explanation of testing a valuation in a different way, and I would love to hear from readers as to whether this alternative approach makes more sense to them. It is more apt to give the attorney a better smell test rather than teaching them the intricacies of the valuation process.

First, the Hierarchy of Risk

Keep in mind that when investors put their hard earned or guaranteed borrowed money in a business they want a rate of return on their investment commensurate with the risks associated with the investment. For instance, a risk free rate of return for a <u>twenty year</u> U.S. Treasury investment is hovering around 3%. Going up the risk ladder, corporate long term bonds are near 5.5%, the S&P 500 long range stock outlook, as commensurate with history, is approximately 10-12%, and smaller public company stocks range from 14% to 20%. Therefore what should the rate of return be for a small closely held (likely micro managed) business? The answer is most definitely between the mid range of small cap stocks and a number that is quite a bit larger. The *after corporate level tax* rate of return for small businesses generally range, with exceptions, from 16% to 26% depending on the quality of the company and a host of many other factors. Again, this is not the rate of capitalization but the rate of return. The capitalization rate (which is the earnings divisor) equals the rate of return less a long term growth rate. And finally, the inverse of a capitalization rate is a multiple of earnings or a price/earnings ratio.

Some Different Terms and Definitions

- **EBITDA**-<u>E</u>arnings <u>b</u>efore <u>i</u>nterest, <u>t</u>axes, <u>d</u>epreciation and <u>a</u>mortization- Simply taking <u>adjusted</u> income and adding back the various items to get EBITDA. This is a common

measure of income by which Business Brokers and buyers will multiply by a number to estimate the potential value of a company they are selling.

- **Owners Discretionary Income (ODI)** –Another commonly used business brokerage term that equals the adjusted income from the business and adding back owners compensation and perquisites as well as interest, depreciation and amortization.. This is the total available earnings to an owner including his/her salary. Alternatively ODI is simply EBITDA plus owners compensation.

Thinking Like a Business Broker

Our accounting and consulting practice has a merger and acquisition segment in which we generally act as a buyer's agent. In addition, we perform the valuation analyses and determine the adjusted income derived from the businesses. Of course, when a person is selling their business they are much more forthcoming about the "perqs" they take from the business or the amount of income they do not report than what we encounter in a divorce or other litigation situation. The glass is half full vs. the glass is half empty.

What I love about business brokers are that their approach to estimating value is so simplistic. However, when used with some common sense, their simplistic approach actually converts to values that business appraisers should generally approximate using more sophisticated approaches. Because most small business brokers are more sales oriented and lack the formal training of titled business appraisers, they will tend to put the estimated values of businesses in their simplest form at multiples of adjusted EBITDA or ODI (As defined earlier). This is something that the majority of non appraisal professionals should be able to comprehend.

Business brokers and other merger and acquisition professionals use the EBITDA multiple as if it were the gospel. The goals of the broker is to sell the closely held "bricks and mortar" or non-high tech types of small businesses for a multiple of between 2.5 and 8 times EBITDA with the central tendency being in the 3 to 5 times range. "Bricks and mortar" business means a low technology service business such as an engineering firm or a low technology manufacturing firm such as a custom metal fabricator or food manufacturer or a wholesaler or retailer of common or custom goods. This is as opposed to a technology driven company that owns sophisticated intellectual property such as software or biotechnology. The technology driven companies, especially ones that are new or that have not reached a profitable status, are rarely valued using the business broker approach.

With internet data nowadays the EBITDA multiple can be supported with public company comparables so in current times we are using this metric more and more in our valuation practice.

Brokers less commonly but (often enough) use the multiple of Owners Discretionary Income (ODI) when estimating the asking price for smaller businesses. This multiple tends to be between 1 and 4 times with the central tendency being 1.5 to 3.5 times. You see this measurement in Rule of Thumb books just as often as you see valuation multiples of revenues and, quite frankly, it is an easier measurement than the multiple of EBITDA to apply because one does not have to perform a fair salary to owner assessment which is a sticking point with many valuations.

However, this methodology is more apt to be used with small businesses that earn ODI under $500,000 because the greater the income, the more the multiple of ODI gets closer to the multiple of EBITDA. This is because the only item that separates the two defined incomes is fair compensation to the owners, and as income gets greater, the less meaningful the fair salary generally becomes, hence this measurement becomes less meaningful when the ODI becomes in excess of $500,000. I have also found the ODI multiple is not generally usable with medical or law practices or other professional businesses where fair compensation varies widely from specialty to specialty.

Why EBITDA or ODI

Using EBITDA or ODI is a less sophisticated way of estimating a company's debt-free cash flow which is the true measurement of determining a return on investment. In most instances it does not truly represent cash flow due to changes in non cash balance sheet items such as accounts receivable, inventory and accounts payable as well as purchases of capital equipment. Nonetheless, it is still the most commonly used measurement of income for valuation purposes in the business brokerage community.

Applying Multiples of EBITDA

The following illustrates how brokers apply the EBITDA multiples method, (you will still need to hire valuation accountant and/or business appraiser to perform most of this task because it will require forensic accounting to adjust the income statement to what is supposed to be the "true income.") However, you, as a non valuation person, can better question the results that the appraiser expert concludes with traditional methods by taking his/her numbers and applying a multiple:

	EBITDA Multiple		**ODI Multiple**	
Company Data-Calculating EBITDA:				
Unadjusted Income before taxes	$ 165,000		$ 165,000	
Add back: Owner's Salary	200,000		200,000	
Add back Owner's Perquisites	42,000		42,000	
Add Back Interest	22,000		22,000	
Add back Depreciation and Amortization	34,000		34,000	
Adjusted ODI	**463,000**		**463,000**	(A)
Less Fair Owners Salary	(125,000)			
Adjusted EBITDA	**338,000**	(A)		
Next Year Income Growth Rate	*20.0%*			
Business Broker Method				
Multiple of EBITDA/ODI Goal	4.00	(B)	3.00	(B)
Goal Selling Price before debt	**1,352,000**	**(A) x (B)**	**1,389,000**	**(A) x (B)**
Less Interest Bearing Long Term Debt	(250,000)		(250,000)	
Goal Proceeds to seller	**$ 1,102,000**		**$ 1,139,000**	

Notice how simple it is to simply take the EBITDA or ODI number and multiply that number by a single digit number rather than dividing it by the all confusing capitalization rate. Also note

that the valuation result includes operating balance sheet assets such as the minimal cash needed to operate, accounts receivable, inventory, prepaid expenses, fixed assets, accounts payable and accrued expenses. **The resulting value does not include excess cash, investment assets, real estate and other assets and/or liabilities that are not part of normal operations. Interest bearing debt also needs to be subtracted.**

Why Subtract Debt?

The EBITDA/ODI multiple is a debt free number; therefore interest bearing long term debt is subtracted from the results.

Applying the Conventional Capitalization of Earnings Method

The following illustrates how an appraiser would apply traditional valuation methods to the above company:

Conventional Valuation Methods used By Appraisers-Capitalization of Earnings				
Adjusted Pretax Debt Free Income			$ 304,000	(after depreciation)
Income taxes			(121,600)	
Adjusted Pretax Debt Free Aftertax Income			182,400	
Projected Next Years Income	C		218,880	20% growth for next year
Required Return		19%		
Long Term growth Rate		-3%		
Capitalization rate	D		16%	
Value of Operating Assets	'(C)/(D)		1,368,000	
Less Debt			(250,000)	
Net Appraised Value of Business			$ 1,118,000	
Multiple of EBITDA Using Conventional Approach			**3.93**	

The above illustrated that both the EBITDA/ODI multiple goals of the broker and conventional valuation methods can and should come out similar. The conventional methods however are considered more concise and the broker method is an estimate.

Usually for growing, profitable small businesses (cash cows) a business broker will ask for five times EBITDA- however this multiple is generally too high for an investment buyer in a smaller business because usually it will be very difficult for them to realize any cash flow return on their investment for several years. This is because most investment buyers borrow much of the purchase price and have to pay back the debt within 5 to 7 years using after tax profits thusly draining any available cash flow for a return on their own investment. Hence, an ordinary investment buyer will rarely pay that multiple. The ordinary investment buyer is the hypothetical buyer in the "willing buyer/ willing seller" scenario that one has read about under the fair market value standard.

Low EBITDA Multiples (Below 4)

The following are the characteristics of companies that will be valued at a lower EBITDA multiple:

- Slow or no income or sales growth
- Aging customer base
- Aging technology or factory equipment
- Industry losing business to overseas companies or phase out, due to obsolescence
- Heavy reliance on a few customers
- Heavy reliance on a few vendors.
- Very little industry merger and acquisition activity (not always applicable in a litigation setting)
- Accounting Books and Records are inadequate
- The success of the business is solely tied to the owner ie. professionals (not applicable in a litigation setting)

High EBITDA Multiples (5 or higher)

We work with several private equity groups that buy controlling interests in businesses, and their purchase price of a strong growing businesses is generally in the 5 to 7 times EBITDA range but many times higher multiples if there is competition between equity groups bidding on the same company. These groups are well financed and generally have expertise in the businesses they buy; therefore while they could be considered a sophisticated investment buyer they are many times a *synergistic* buyer. Many of these groups only buy companies that are greater than say $30 million in sales and have greater than $5 million of EBITDA. Generally, they will buy companies with the following characteristics:

- Depth of management- they will not buy businesses that are so tied to the selling owner(s) that the customer base or product quality will erode once the owner is gone. The buyer is looking for non owner management and a sales force that will stay with the company after the purchase.
- Historical strong sales growth with the potential to grow faster with a fresh infusion of cash or other forms of capital.
- Diverse customer base- nothing kills an acquisition deal faster than the dependency of a company on a few customers unless the customers cannot go elsewhere or are legally tied to the product and company.
- Proprietary Products-Products that are exclusive to the company.
- Diverse supplier base- Many wholesalers of goods are reliant on foreign manufacturers to make their products. If the company is relying on one vendor, that is a red flag to the equity groups unless they can make the products themselves- in which case they become a synergistic buyer.
- High gross profit margins and high net profit margins-This speaks for itself.
- Good management of inventory and receivables- The buyers look for the accounts receivables to be collected faster than the industry standard and for inventory to turnover faster than the industry standard. The ability of the company to quickly convert their sales to cash is very valuable.

- Low Capital Expenditure requirement

Which EBITDA/ODI to Use

Now is the age old question of whether one uses an average, weighted average or most current year EBITDA to apply a multiple to for value. The number used should be indicative of the future income stream. Do not forget, the true value of a company today is based upon what the expected future income will be. Sometimes it is measured by history or the most current year, and other times it is measured by a present value of future income.

From an historical income perspective, the following are examples of historical EBITDA patterns and what should be used for valuation purposes just from a gut instinct as the measure of value:

	2004	**2005**	**2006**	**2007**	**2008**	**Weighted Average**	**Likely Suggested Number**	
Company 1	100	120	160	180	210	173	210	Most current year
Company 2	100	80	110	100	95	98	97	Average 2004-2008
Company 3	100	90	80	70	75	78	75	Average 2004-2008
Company 4	100	90	80	70	60	73	60	Most current year
Company 5	100	90	90	110	140	113	140	Most current year

Every situation has its own facts and circumstances, however an appraiser should not use an average unless the historical income trend justifies using it, and the most current year should not be used unless the trend justifies it. For instance in Company number 1, using an average will likely under-value the company because its growth trend clearly reflects that the company is likely not going to be earning the earlier years' income in the future and is clearly in a growth pattern. Company number 2, on the other hand, has an irregular pattern with up years and down years. Clearly the use of an average would likely be justified. Because of the uncertainty in the current economy, averages are being used more often.

The Earn-out

More and more deals today contain contingent future payments, based on milestones reached by the 'sold' business. Suppose a seller thinks their business will grow 25% per year for the next few years, and they believe that would justify a higher multiple of EBITDA (or higher price). But in the buyer's predictions they see 10% growth expectations going forward. To close the purchase price gap, both sides can develop and agree to payments in the ensuing years that would be contingent on hitting certain milestones. This can help motivate the seller to work toward business continuity and continued growth, with rewards for success. And at the same time this approach can limit the cost and therefore the risk for the buyer, if the growth expectation does not manifest as the seller foresaw.

Conclusion

As I assume you have been running and operating your business for some time, I am sure you have come to realize it is more complex than the ideas you had when you started it. Not just a good product or service done right, at the right price, but much more. Complex too, is the valuation process and maximizing your business' value for a sale. As you have read, there are a lot of moving parts, many different variables that drive value and more than one way to view, transact and transfer that value to others.

One certainty though is that the sooner you begin to focus on value, the more prepared you will be to run your business with that value in mind.

Most importantly, if you are considering selling your business and desire maximum value for this typically sizable asset, it will require some, and often times much, prior preparation. Our team is well versed, experienced and expert in measuring value and helping businesses to prepare, and most times enhance, value before and during the sale process.