Arbor
Valuation and Consulting

How Understanding Business Valuation Can Make You a Better Financial Advisor

I. Introduction

Most financial advisors are probably comfortable in discussing value as it relates to the capital markets. How often do you look at P/E ratios or hear someone discuss a stock being over or under valued? Have you ever scratched your head at hearing about the stratospheric values of Silicon Valley IPOs and questioned how these figures were estimated? These examples represent types of business valuation, but what about privately held small and mid-market companies? The valuation of these firms is something that most financial advisors are not familiar with, but a basic understanding of the process could prove helpful in working with clients who own businesses.

There are roughly six million privately held operating companies in the United States. Baby boomers own around 2/3 of these businesses and will need to transition out over the next ten to fifteen years. There is a good chance that as a financial advisor, you have a client who owns one of these businesses or will inherit one of these businesses. The firm often represents the largest portion of this client's wealth.

Do you think your client knows what his or her business is worth? The likely answer to this question is no. In a survey of privately held firms, the Exit Planning Institute found that only 18% of owners had a business valuation performed within the last two years. In the same survey, 56% of owners thought they had a good idea as to the value of their firm. These owners may have a clear picture of their firm's value, but 95% of advisors in the Alliance for Mergers & Acquisitions believe that the #1 reason for failed M&A transactions is a misalignment between an owner's perceived value and the market value of their firm.

The suggestion here is not that you and your client need to run out and schedule a valuation this afternoon. Valuation is generally required for big events in the life of a firm or its owners, but it can also be a great tool in planning ahead for these events. You should be working with your client to ensure that exit plans and contingency plans are in place well before they are needed. An exit planning advisor can add tremendous value to this process. These professionals work with you, your client, the valuation analyst, lawyers, CPAs and other advisors to prepare the firm and the owner for an eventual exit.

Given that your client's largest source of wealth is probably their business, it is helpful understand how valuations are performed and when they are needed. The following discussion will (1) identify events that trigger the need for valuation; (2) briefly describe how business valuation is performed; and (3) provide information about finding professional valuation experts.

II. When Will Your Client Will Need an Opinion of Value?

There are times in the life of a privately held business (or its owners) that a certified opinion of value is required. These occasions generally fall into three categories: business transactions; litigation; and taxes. If your client owns a firm that is involved in acquisitions, there will be a fourth category – financial reporting. Your client's CPA firm will oversee and outsource any valuation work for financial reporting. In a certified opinion of value, the valuation analyst will produce a report that discusses the purpose of the valuation, the assumptions; the methodology; and the conclusion of value.

A. Business Transactions

Small and mid-market firms (or minority interests in these firms) need to be valued when

- owners want to buy and sell shares between themselves
- a firm or a minority interest is being sold to a third party or family member
- an ESOP is established - valuations then occur on a regular basis
- a management buy-out occurs
- a bank requires a valuation as part of financing
- exit planners and business owners prepare for a transition

B. Litigation

Litigation is another big driver for valuation. Divorce is probably the most common type of litigation that requires valuation. If one spouse owns all or part of a privately held firm, this firm needs to be valued in determining the assets in the marriage. Valuation is needed whether the divorce goes to court or is settled through a mediator (when they will typically use one expert rather than two). Unfortunately, divorce frequently requires valuators to be well versed in financial forensics as there are often personal expenses and balance sheet items buried in the company financials that are relevant to the divorce proceedings. Other types of litigation requiring business valuation include bankruptcy, owner disputes and the calculation of lost profit damages.

C. Estate and Gift Tax

Some of the most talented valuation professionals work for one employer. Can you guess who that employer is? The IRS! There are two ways in which the IRS looks at the valuation of privately held firms. The first is in the realm of estate tax, and the second is in gift tax. These taxes apply when the owner of a firm dies or gives shares of that firm to another person (typically a family member).

Many valuation professionals are also CPAs. The reason for this is that they started doing valuations for estate and gift tax reporting. In small firms, these professionals usually do a few valuations each year (if at all). Large accounting firms have valuation departments that do tax related valuations, and they also do valuations for business transactions and other purposes.

III. Valuation Methodology

A description of valuation methodology could easily cover hundreds of pages. Why is valuation so complicated? To answer this question, just think for a moment about a solid, well-performing enterprise. That enterprise is made up of people, machinery, technology, customer relationships, processes, intellectual property, trade secrets, brand equity, etc. Most of the items in this list do not appear on the balance sheet of the corporation. These strengths are known as intangible assets. These have value, but someone needs to be able to quantify that value in dollars (or euros or another currency). This is where the valuation analyst comes in.

Valuation methodologies can be boiled down into three major categories: Asset Approach; Market Approach; and Income Approach. A valuation analyst will typically perform all three approaches. Then, each approach will either be rejected or weighted to determine the base value. This base value may be subject to “discounts”, depending on the characteristics of the interest being valued.

The Asset Approach

The Asset Approach is the simplest in that it looks at the book value of the net assets. After the discussion above about intangible assets, you may question why this approach is considered. A value derived through the Asset Approach is typically the “floor value” for any firm. For a business that is a thriving, on-going concern, this value is rarely used. The Asset Approach is most appropriate for firms that are in distress or for holding companies.

The Market Approach

The Market Approach uses multiples derived through prior transactions of similar companies to determine the value. The analyst will review the subject company’s financial statements and adjust for expenses and balance sheet items that are personal or non-recurring in nature. The analyst will then use various databases to find the selling prices of firms in the same industry over the past several years. These databases also contain the annual sales and EBITDA figures for the firms in the transactions. Firms that are too unlike the subject firm will be removed from the data set. Two multiples are generally determined: the sales multiple and the EBITDA multiple. These multiples are applied to the subject firm’s sales and EBITDA to estimate the value of the firm.

The Income Approach

The Income Approach determines a present value of the future cash flows of the firm. The two most common methods within the Income Approach are the Capitalization of Earnings Method and the Discounted Cash Flow Method. The Capitalization of Earnings Method is frequently used for companies that have relatively predictable earnings. The Discounted Cash Flow Method is used by sophisticated buyers, large corporations, start-ups, high-growth companies, and firms operating in uncertain economic environments (e.g. COVID). To use the Discounted Cash Flow Method, the analyst should have a business plan with financial projections. This is often a non-starter in valuing smaller firms that do not have three to five-year business plans.

Discounts

Once a base value is determined by rejecting or weighting the value derived through three approaches, the valuation analyst may apply a discount to the base value if it is warranted. The two most common discounts are Discount for Lack of Control and Discount for Lack of Marketability. The first discount applies to minority interests, which inherently lack the control to make strategic decisions in the firm. The Discount for Lack of Marketability is applied to consider the fact that it is more difficult to market the shares of privately held firms. If there is a ready buyer, this discount would not be considered. Many factors go into quantifying these discounts, and the analyst may need to apply additional discounts for things such as built-in capital gains or excessive reliance on a key person in the firm.

A Wonderful Thing Happened on the Way to the Value

A valuation report will include information that is compiled by the analyst and is useful on a stand-alone basis to business owners. The report will include an economic outlook for the industry, and it will include a peer comparison which evaluates the company relative to its industry peers on financial metrics. For owners of privately held firms, this information is often new and very informative.

IV. Valuation Professionals

If your client needs to have a valuation performed, it should be done by an accredited valuation professional. Accredited professionals must adhere to professional standards and stay current through continuing education. Because of this, these professionals can be counted on to perform thorough, objective analyses. There are firms that specialize in valuation, and most large accounting firms have valuation departments. A listing of locally accredited valuation professionals can be found on the NACVA (National Association of Certified Valuators and Analysts) website at www.NACVA.com.

If you have additional questions about business valuation, please contact:

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