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What’s It Worth? Valuing a Business for Sale

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If you’re thinking of buying or selling something (anything), it’s important to know the value of that thing. Whether a piece of art, a shirt, a house, or a business.

Perhaps the best definition of the value of a thing is that the thing is worth what a buyer is willing to pay and what a seller is willing to receive for that thing. That’s a tautology, however.

Valuing a business is useful, if not necessary, in a variety of circumstances. Some examples include when a business is seeking a bank loan, when a business’s owners are divorcing (either figuratively or literally), and when a business is getting ready to be acquired (or, from the perspective of the would-be acquirer, when it is a potential target).

This article is intended as a brief introduction to the subject.

It’s important to note that valuation is not a one-size-fits-all process; different methods provide different insights, and the choice of method depends on the specific circumstances and purpose of the valuation. As Megan Becwar, principal at Dispute Economics, puts it, failing to match the intended purpose of the valuation with the correct valuation method for that purpose will likely result in an incorrect (or irrelevant) conclusion of value.

Importance of Accurate Business Valuation

An accurate valuation of a business in the context of a potential M&A transaction is important to a seller because overpricing can lead to a business lingering on the market while underpricing means the owner leaving money on the table. Moreover, a well-substantiated valuation can withstand scrutiny during negotiations, audits, and legal proceedings.

Methods of Business Valuation

There are several approaches to business valuation, each with its own set of methodologies and assumptions. The three primary methods are:

1. **Income Approach:** This method is based on the principle that the value of an asset is the present value of its expected future economic benefits. Discounted Cash Flow (DCF) Analysis

is a common technique under the Income Approach. It estimates the present value of expected future earnings. This approach is particularly useful for businesses with stable and predictable cash flows.
2. **Market Approach:** The Market Approach compares the business to similar companies that have been sold, using industry multiples such as the Price-to-Earnings (P/E) ratio or Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) multiples. It relies on the principle of substitution, suggesting that a prudent buyer would not pay more for a business than the cost of acquiring a similar one. This approach is most effective in active markets with ample comparable transactions.
3. **Asset-Based Approach:** This method values the business based on its tangible and intangible assets, subtracting liabilities. It considers the net asset value, essentially calculating the difference between total assets and total liabilities. This approach is often used for companies with substantial tangible assets or those facing liquidation, as intangible assets must be separately valued.

Understanding the nuances between intrinsic and relative valuations is important.

- **Intrinsic valuation** is based on widely accepted academic methods, but assumptions can be manipulated.
- **Relative valuation**, on the other hand, depends on actual market dynamics.

John Levitske of HKA Global notes that these distinctions underscore the importance of both selecting the appropriate valuation method and being mindful of the assumptions underpinning each approach.

Legal Considerations in Business Valuation

Legal factors play a pivotal role in business valuation, influencing both the valuation process and the final assessed value. Key legal considerations include:

1. **Fair Market Value vs. Fair Value:** Understanding the distinction between these terms is crucial. Fair Market Value (FMV) represents the price at which a property would change hands between a willing buyer and a willing seller, with neither under compulsion and both having reasonable knowledge of relevant facts. Fair Value, however, is a legal standard often used in shareholder disputes and may not consider discounts for lack of control or marketability. Richard Claywell, Certified Public Accountant, explains that fair market value assumes a hypothetical buyer and seller, while an actual transaction involves real-world negotiations, synergies, and motivations.
2. **Minority Discounts and Control Premiums:** A minority interest in a company may be less valuable due to the lack of control over business decisions, leading to a minority discount. Conversely, a controlling interest may command a premium. The application of these adjustments depends on the specific circumstances and the standard of value being used.
3. **Buy-Sell Agreements:** Buy-Sell Agreements outline the terms under which a business owner's interest can be sold or transferred, often specifying the valuation method to be used. Properly drafted buy-sell agreements can prevent disputes and provide clarity during ownership transitions.
4. **Legal Structure and Compliance:** The legal structure of a business (i.e., sole proprietorship, partnership, corporation) affects its valuation due to differing tax implications, liability issues, and regulatory requirements. Ensuring compliance with all applicable laws and regulations is vital, as legal issues can significantly diminish a company's value.

***Editors' Note:** Legal structure is also significant for estate planning purposes. See Estate Planning for the Business Owner Series, Part 3: Examples of Business Transfers and Valuations by Andrew Haas of Blank Rome LLP to read more about this.*

Financial Considerations in Business Valuation

Financial factors are at the core of business valuation, providing quantitative measures of a company's performance and potential. Tom Walsh of Brody Wilkinson PC emphasizes the role of due diligence, noting that a buyer will scrutinize everything, from vendor contracts to customer concentration risks.

Key financial considerations include:

1. **Financial Performance:** Strong revenue, profitability, and growth prospects enhance value. Analyzing historical financial statements provides insights into the company's earnings stability and operational efficiency. Potential buyers often scrutinize metrics such as gross margin, operating margin, and net profit margin to assess financial health.
2. **Cash Flow Management:** Cash flow is the lifeblood of any business, and its management directly impacts valuation. Buyers focus on free cash flow (FCF) as an indicator of a company's ability to generate profits and sustain operations. Effective cash flow management can significantly enhance a company's attractiveness to buyers.
3. **Debt and Liabilities:** The level of debt and financial obligations influence business valuation. A company with high debt levels may be considered riskier, potentially leading to a lower valuation. Conversely, a well-managed capital structure with manageable liabilities can enhance valuation by demonstrating financial stability.
4. **Industry and Market Conditions:** The external economic environment, industry trends, and market demand play crucial roles in determining business value. A company operating in a high-growth sector may command a higher valuation than one in a declining industry. Investors often look at comparable market transactions to gauge valuation expectations.

Conclusion

By understanding different valuation methods, preparing in advance, and seeking expert guidance, business owners can maximize their company's worth and ensure a successful transaction. Whether you're planning to sell now or years down the road, starting the valuation process early is one of the smartest business moves you can make.

To learn more about this topic, view What's it Worth? Valuing a Business for Sale. The quoted remarks referenced in this article were made either during this webinar or shortly thereafter during post-webinar interviews with the panelists. Readers may also be interested to read other articles about valuation.

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