HIGHTOWER
Great Lakes

Understanding Business Value

Hightower Great Lakes

Valparaiso, IN
Traverse City, MI
Chicago, IL
hightowergreatlakes.com

Introduction

A successful Exit Plan results in the business owner exiting their business with the financial resources to meet their future needs. In Step Two of The BEI Seven Step Exit Planning Process™, Exit Planners work with business owners to quantify the value of their assets as well as the financial needs of the business owner following the sale of their business. Once each of these has been quantified, Exit Planners can determine whether there is a gap between them. If a gap exists, the Exit Planner can create a plan to close that gap.

Assessing the gap is an essential step in creating a successful Exit Plan. This paper will focus on one aspect of assessing the gap: the benefits of a business valuation when determining the value of what is typically the business owner's biggest asset—the interest in their business.

Ascertaining the value of a business owner's assets is paramount if an Exit Plan is to be considered successful. It is common to hear Exit Planners state that business owners know the value of their businesses. It is also common to hear Exit Planners state that a business owner's estimate of value turns out to be materially different than the actual transaction price at exit. Uncertainty about the value of the business interest can materially increase the probability that a gap could arise at exit and leave the business owner without the assets needed post-exit. A quality business valuation can improve the probability of a successful exit event, since a gap can be identified and a plan to eliminate the gap can be prepared and implemented. In addition, preparation of a business valuation will use approaches that are consistent with that of a financial investor.

Therefore, completion of a valuation years before the planned exit event can be an excellent practice run to experience the due diligence process that a potential buyer would typically complete. The valuation also provides comparisons to benchmarks that may assist the business owner with identifying opportunities to increase the value of their business during the years prior to their planned exit date. As such, the benchmarking completed as part of a valuation may be a key part of developing a plan to address a gap. Let's discuss a few common valuation methods, along with the advantages and pitfalls of each.

Rules of Thumb

It is common for business owners to have a general idea of their industry's rules of thumb. Common rules of thumb are based on multiples of revenue or EBITDA. Simple to use, one basically takes the commonly shared multiple for their industry and applies it to the subject company's revenue or EBITDA. For example, a common rule of thumb for insurance agencies is 1.5x to 2x commission revenue. This implies that an insurance agency with commission revenue of $2 million has a value ranging from $3 million to $4 million.

While rules of thumb are simple to apply, one needs to use caution with the results. Rules of thumb tend to be self-supporting. Stated another way, the multiples people are considering today came from past transactions that may have been based on the same rule of thumb. Also, not all companies in an industry are created equal. Consider two insurance agencies with $2 million of commission revenue. One has a high level of cash flow and the other has a lower level of cash flow. Do they both have a value ranging from $3 million to $4 million? Where a subject company falls in this range is impossible to determine without completing an analysis that benchmarks the subject company to other comparable companies.

Guideline Transactions and Publicly Traded Companies

One can look at past transactions of companies or the prices investors are paying for publicly traded companies that can be considered reasonably comparable to the subject company. Some industries lend themselves to this approach better than others. For example, there are several comparable transactions and publicly traded companies to consider when estimating the value of an automobile dealership. Very much like the rule of thumb method, multiples are derived from the transactions or public companies and applied to the subject company.

However, use of transactions and public companies allows the selection of the multiple to be fine-tuned based on the subject company's financial performance and risk factors relative to the transactions or public companies. For example, one can consider the company's Value Drivers—which guide what a company is worth without the owner—such as the subject company's growth, profitability, diversity in products sold, and management team strength.

Information shared in filings of publicly traded companies is very detailed and can be used to identify opportunities to improve the value of the subject company. This can be particularly important when a gap between the value of the subject company and the owner's financial needs has been identified.

For example, consider a subject company that is less profitable (lower cash flow) compared to publicly traded companies. Further analysis determines that the subject company's cost of goods is materially higher than the cost the publicly traded companies typically pay. With this information, the Exit Planner can work with the subject company's management and other consultants to start exploring options to reduce their cost of goods sold. The benefit is improved cash flow, increased value, and a decrease in the gap.

Income Approach

This approach considers the subject company's ability to generate cash flow and estimates the value based on that cash flow. This involves defining expected cash flows and a required rate of return. Expected cash flows can be estimated using a historical review of the company's financial performance (often referred to as a capitalization approach) or use of explicit projections of future cash flows (often referred to as the discounted cash flow method). Thereafter, the subject company's weighted average cost of capital, or WACC, is estimated and applied to the cash flows to determine the value of a business.

The rule-of-thumb and guideline-company approaches may be used in conjunction to confirm the reasonableness of the concluded business value when using an income approach.

In addition to an estimate of the subject company's value, another benefit of using an income approach is the usefulness of the information that is yielded. The income approach involves reviews of the subject company's operations; considers strengths, weaknesses, opportunities, and threats; and weighs performance relative to benchmarks. While a company's cash flows may be reasonably easy to estimate, assessing the risk of those cash flows is paramount when estimating a business' value.

For example, Company A derives 80% of its cash flows from a single customer. Company B derives no more than 5% of its cash flows from any single customer. It would be reasonable to apply a higher WACC—resulting in a lower company value—to the cash flows of Company A, due to the riskiness of Company A's cash flows based on its heavy dependence on a single customer.

A thorough application of the income approach can greatly assist with closing the gap between a business owner's assets and the financial needs of the business owner following the sale of their business. Very much like benchmarking using publicly traded companies, an income approach can identify opportunities to improve the subject company's cash flows and/or reduce the risk of those cash flows. This can lead to an increase in value.

Conclusion

In Step Two of The BEI Seven Step Exit Planning Process, Exit Planners work with business owners to quantify the value of their assets as well as the financial needs of the business owner following the sale of their business. There are several approaches to completing an assessment of the business owner's assets. Applying a rule of thumb may provide an approximate estimate but gives little information regarding improving the cash flow of the subject company. Use of guideline companies and/or the income approach provides a value conclusion using an approach consistent with that of a financial investor. These methods also provide comparisons to benchmarks that may assist the business owner with identifying opportunities to increase the value of their business during the years prior to their planned exit date.

It is wise to expect that financial buyers will complete a thorough review of the subject company. They will be looking to confirm that the cash flows are sustainable after the business owner leaves the company and that those cash flows are not subject to other risks, such as customer or supplier concentrations. Therefore, completion of a thorough valuation years before the planned exit event can be an excellent practice run to experience the due diligence that a potential buyer would typically complete. Given that Exit Planning should start years before the exit event is planned, preparation of a thorough valuation can provide business owners with the information necessary to increase the value of their business.

Obtaining a quality estimate of a business' value can reduce the risk of identifying a material gap later in the Exit Planning Process. As John Brown—the creator of The BEI Seven Step Exit Planning Process—has stated, a successful Exit Plan results in the business owner exiting their business with the financial resources to meet their needs following the exit. Therefore, estimating the value of the business owner's assets and identifying the gap early in the process is critical to the success of an Exit Plan.

Takeaways

- A quality business valuation improves the probability of a successful exit event, since a gap between a business owner's assets and the financial needs of the business owner following the sale of their business can be identified, and a plan to eliminate the gap can be prepared and implemented early in the Exit Planning Process.
- Estimates of business value can be obtained from rules of thumb, guideline companies, or use of an income approach.
- Benchmarking to publicly available information completed during the business valuation process can assist in identifying value improvement opportunities and closing the gap.
- Engaging in a business valuation will result in a due diligence process that is consistent with that of a financial buyer. This is an excellent opportunity for the business owner to experience the due diligence process.

Please note that the advisor providing this information may not offer business valuation services. This information is for general educational use only. If you require business valuation services, we encourage you to use a certified business valuation specialist.

This white paper was authored and provided by Empire Valuation Consultants, LLC, to be used by members of the BEI Network of Exit Planning Professionals, subject to a valid license agreement.

Content in this material is for general information only and is not intended to provide specific advice or recommendations for any individual. Additionally, it is not to serve as a substitute for specifically individualized tax or legal advice. If you have a concern regarding your specific situation, please discuss it with a qualified tax or legal advisor, or contact us today.

HIGHTOWER
Great Lakes

15 N. Franklin Street, Suite 100, Valparaiso, IN
10850 E. Traverse Highway, Suite 3350, Traverse City, MI
200 W. Madison, Suite 2500, Chicago, IL

hightowergreatlakes.com