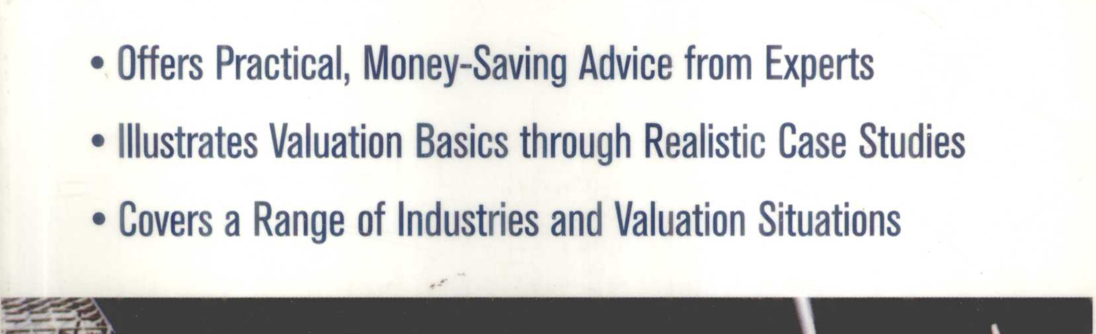
What Every Business Owner Should Know About Valuing Their Business

- Offers Practical, Money-Saving Advice from Experts
- Illustrates Valuation Basics through Realistic Case Studies
- Covers a Range of Industries and Valuation Situations



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PREFACE

PURPOSE

The primary purpose of this book is to provide owners of privately held businesses or professional practices with a working understanding of the determinants of the value of their business.

PAYOFF

While knowing the value of a business is typically not essential to successful day-to-day operations, there likely will come a day when this knowledge can make a critical difference in how well an owner will be compensated for the many years of work and the risks taken to build the business. Unless an owner plans simply to close the business on retirement, understanding the ways that potential buyers, the Internal Revenue Service (IRS), and business brokers will determine the value of the business can be one of the best investments of time that an owner can make.

BUSINESS VALUATION IS COMPLEX . . .

Understanding valuation is no small task because the value of any business is related to factors that are complex to determine and generally costly to obtain. The language of finance, and valuation in particular, is arcane, and the process by which most valuations are done takes the form of "black box" calculations. As a general rule, the objective of a business valuation is *not* to educate an owner on what the business is worth; rather, the focus is on developing a valuation estimate that is defensible to other valuation experts.

BUT UNDERSTANDABLE

Most business owners have developed a working knowledge of accounting issues important to their business without fully mastering all aspects of double-entry bookkeeping. Owners know where to go for help, and they have a sense of what the help should cost. They know what questions to ask, and they have a context for evaluating the answers. This should be the starting-point objective for owners in understanding business valuation.

OUR APPROACH

Our approach combines basic information about different methods of business valuation illustrated through case studies set in several different industries. While the valuation issues are different for professional practice firms and for manufacturing firms, for example, the business transition issues are often identical.

The case studies highlight other practical business transition issues facing owners beyond valuation, including

1. The pros and cons of different methods for selling a business
2. Reasons why the sale price of a business may differ from the fair market valuation estimate
3. What skills and experiences owners should look for in advisors to help in planning for the inevitable business transition

WHAT WE ARE

bizownerHQ is an expert valuation services firm. We have reengineered traditional valuation processes to achieve an unbeatable combination of accuracy, consistent high quality, transparency, speed, and cost-effectiveness for our business valuation services. We achieve this through leveraging

1. Internet technology for fast, high-quality, and low-cost information collection and distribution
2. Expanded industry-specific data availability
3. Improvements in industry analysis and modeling capabilities
4. Software for automating the customization of reports
5. Advances in peer-reviewed financial research on business valuation

Valuation is at the center of most business life events facing owners of independent businesses. Business life events include selling a business, making changes in the ownership structure, retirement and estate planning (including the value of a business), and protecting owner income and equity. Business life events, the one thing all small business owners have in common besides being small, are high-stakes issues that have a major impact on an owner's financial success. Managing these events is generally outside an owner's experience. Our research shows that many owners have put off addressing these issues due to a combination of uncertainty about what to do, which advisors to rely on, and concerns about how much the solutions to a business life event will cost.

Our mission is threefold:

1. *Take the Mystery Out of Valuation.* Business owners approaching transition can save significant amounts of time and money by knowing the basics of valuation.
2. *Get Owners Focused on Value Maximization.* Most owners manage based on tax minimization. As they approach transition, those planning to sell will benefit from managing their businesses for value maximization (except for selling within a family).
3. *Make Valuation "Valuable" for Owners.* Most business owners find traditional business valuations to be high cost and low value. We provide high-quality, timely, and affordable alternatives to existing business valuation services.

WHAT WE ARE NOT

bizownerHQ is not a business broker and does not sell any insurance, banking, or other financial services. Our valuation work is completely independent, with neither the company's executives nor investors benefiting from business sales transactions or sales of financial services to owners.

WHAT OWNERS WILL LEARN

For the time invested in reading through the cases in this book, owners will come away with an understanding of the preceding issues and much more:

1. An understanding that they are not alone in having to face business transition issues. The number of owners now beginning to seriously address business transition and related business life events issues is growing rapidly.
2. Practical knowledge of the three primary methods of small business valuation.
3. An understanding of reasons why determining the valuation of a privately held business is so much more difficult than determining the valuation of a publicly traded business.
4. An appreciation of the risks to an owner's retirement portfolio where the dominant asset is the value of the business.
5. An understanding of the valuation methodology used by bizownerHQ to value a business.
6. An appreciation of how the power of the Internet is reducing the barriers and therefore the costs of obtaining a privately held business valuation.

7. An understanding of when an owner should commission a professional valuation of the business and what questions he should ask in the valuation selection process.
8. An understanding of how the information an owner provides to the valuation consultant can influence the valuation result.

INTRODUCTION

THE COMING BUSINESS TRANSITION TIDAL WAVE . . .

The revitalization of the small business economy in America has been a central factor in the economic progress of the last 25 years. Now the entrepreneurs who started this charge have begun to retire. Over the next decade, an unprecedented number of businesses will go through some form of ownership transition. Although the importance of the small business economy to the overall economy has become increasingly recognized over the last 10 years, there has been little recognition of the oncoming business transition tidal wave.

WILL OVERWHELM THE INEFFICIENT SUPPORT NETWORK

The basic professional advisor and financial services support structure for small business owners around what we call *business life events* remains primarily local and highly inefficient. Business life events include selling a business, retirement planning, insuring owner income and equity against risks of disability and death, and estate planning. The costs of many owner-related services, including financing for diversification; insurance coverage for business succession and owner disability; business brokerage; and customized advice for retirement and estate planning are perceived as too high by many business owners. The delivery of customized services to owners of businesses and professional practices have shown little improvement over the last two decades despite remarkable advances in technology elsewhere in the economy. For example, it is generally much easier for business owners to obtain short-term financing through personal credit cards than to apply for loans from their banks.

VALUATION IS KEY TO MANAGING BUSINESS LIFE EVENTS

Determining the value of a privately held business or professional practice is an essential aspect of managing business life events. Valuations also have the potential to assist business owners in deciding on which strategies and tactics to undertake. Value maximization, which has become the key driver of management strategies of publicly held companies, also could have a positive impact on the efficiency, effectiveness, and financial results of privately held businesses. While owners of privately held businesses will never have to worry about tracking their value quarter by quarter as their publicly held counterparts do, setting annual objectives for value maximization is likely to have a significant payback over time. This is especially true as the owner or owners approach their likely time for transitioning out of the business.

DRAWBACKS TO TRADITIONAL VALUATIONS

Business valuation is another area of business owner support that has made little progress in terms of efficiency or turnaround time. Understandably, conducting a business valuation is no small task because the value of any business is related to a set of factors that are complex to determine and costly to obtain. The result is that owners who really do need their businesses valued are loath to reach out to an expert for at least three reasons:

1. *High cost/low benefit.* A traditional business valuation runs anywhere from \$5000 to well over \$25,000. Ask a business owner who has paid for one whether he got what he paid for, and most will say *No!*
2. *Short shelf life.* The results of a valuation must be "as of" a specific date; thus the results age quickly. In addition, it generally takes between 4 and 6 weeks to complete a valuation. Owners typically need an answer more quickly.
3. *What does it mean?* Probably the most important concern is that the owner is generally perplexed with what a valuation expert often provides even if the valuation is larger than the owner had expected. The language of finance, and valuation in particular, is arcane, and the valuation process is perceived as coming from a "black box" where the output is "managed" by the professional undertaking the exercise.

GOING FORWARD

In the following chapters we have organized the information into multiple sections that allow owners to gain the key messages of each chapter without having to read through all elements of each chapter. In the first two chapters we focus on two basic questions: Who should have their business valued? and What is a business valuation? We also have highlighted key points in bold and italics with the lead-in ***"Business owners should know. . . ."*** The case study chapters that follow focus on realistic business situations that show different aspects of valuation and business life events across a variety of industry sectors. Following each chapter, we include one or more additional sections. The "Special Focus" section addresses a topic introduced in a particular chapter in more detail. The "Backgrounder" sections address more general issues related to valuing a business. The section entitled "More on Valuation Methods" describes a particular valuation approach and the advantages and disadvantages of its use. For our first "Special Focus" section, we present a summary of the crucial role played by the small business sector in the U.S. economy.

Starting in Chapter 4 we introduce the bizownerHQ Valuation GURU to help the owners in these cases get a reliable business valuation quickly and affordably. We have included examples of the bizownerHQ online summary reports that would be provided in each case. These reports and the company financials, as represented by the business tax return, for each business are placed at the end of each chapter in an appendix.

SPECIAL FOCUS

THE ROLE OF SMALL BUSINESS

The U.S. economy is the largest and, arguably, the most dynamic economy in the history of the world. One aspect of the strength and dynamism of the U.S. economy is its diversity in terms of both the varied types of economic activities and the range of sizes of businesses.

The U.S. Small Business Administration (SBA) defines small businesses as businesses with less than 500 employees. Most small businesses do not sell equity (i.e., ownership shares) to the general public and are also called *privately held businesses*.

bizownerHQ estimates that there are 24.5 million small businesses as of 2001. These are enormously important to our standard of living. According to the SBA,

> Small businesses with fewer than 500 workers employ 53 percent of the private non-farm workforce, contribute 47 percent of all sales in the country, and are responsible for 51 percent of the private gross domestic product. Industries dominated by small firms contributed a major share of the 3.1 million new jobs created in 1998. Over the 1990–1995 period, small firms with fewer than 500 employees created 76 percent of net new jobs.[1]

More women are becoming small business owners. Women-owned businesses are an important part of the growing U.S. economy. Women-owned businesses have expanded at double-digit rates and stand at over 8.5 million firms. These firms have generated well over $3 billion in revenue,

[1]The Facts About Small Business 1999, U.S. Small Business Administration, Washington, DC 20416.

and women-dominated firms have increased the fastest in wholesale trade, manufacturing, and construction. In 1992, the latest available data, 3.5 percent of all women-owned firms and 16 percent of those with 20 to 100 employees were franchises.

Small businesses are innovation leaders. Small firms produce 55 percent of innovations. They produce twice as many of both product innovations and significant innovations per employee as large firms. Small firms obtain more patents per dollar of sales than large firms. Estimated rates of return on total research and development (R&D) in firms with a university relationship are 30 percent for large firms and 44 percent for small firms.

CONTENTS

CHAPTER 1

WHO SHOULD HAVE THEIR BUSINESS VALUED?

VALUATION IS NOT FOR ALL SMALL BUSINESSES

For the 24.5 million small businesses and professional practices, how should the owners determine whether they need a business valuation at some point in the life of the business? To address this question, we have separated the need for a valuation into two categories: required valuations and strategic valuations.

Required Valuations

Many owners of businesses and professional practices will at some point in the life of their business be required to get a valuation as part of a legal proceeding or a tax issue involving the owner. Examples include

1. An owner of a business going through a divorce will need to include the value of her business in the final disposition of the couple's assets.
2. An owner places his ownership of the business into a family trust, and the Internal Revenue Service (IRS) contests the value assigned to the business.
3. The estate of a deceased owner will have to commission a valuation of the business for filing estate tax forms.

4. A business or professional practice with more than one owner generally will need a valuation if one of the owners leaves.
5. An owner facing a court judgment against her net worth may be required to have a business valuation to determine how much the owner can pay toward the judgment.

Owners experiencing these types of business life events or similar ones will have no choice but to pay for a business valuation. The business valuation results in most cases will have a direct impact on their finances. The results will determine an amount they must pay to a spouse, a former partner, a claimant, or the IRS. As a result, owners getting a *required valuation* almost always want the lowest possible value assigned to their businesses.

Strategic Valuations for Managing Business Life Events

For owners who are not required by legal or tax issues to get a business valuation, what should determine whether they choose to have their businesses valued at some point? The simple answer is: If an owner believes that the business is successful enough that it could be sold now or in the future, then getting a business valuation is a crucial step in the strategic management of what we call *business life events*.

What we mean by a business being successful enough is that it has an ongoing value, and therefore, the business entity as it currently exists has a value to a new owner. As a consequence, somebody likely will be willing to pay a price for the right to own the existing business. This ongoing value concept needs to be distinguished from a business's liquidation or termination value. The reason is that a business may have $0 value as an ongoing entity but have a value greater than $0 if the business closed its doors and put its assets up for sale. The proceeds of any asset sale minus any remaining business debts or other liabilities establish the business's liquidation value. In this sense, virtually all businesses have some value; but not all have value as an ongoing enterprise. Unless otherwise noted, throughout this book our use of the term *value* always refers to the value of a firm as an ongoing entity. Therefore, when we say a business has $0 value, we mean that as an ongoing entity it has no value, although it may have value if the business ceased to exist and its assets were sold.

There is somewhat of the "which came first, the chicken or the egg" conundrum in the preceding description. How can an owner know if someone would likely pay her to take over the business without first getting a business valuation. We sympathize with business owners facing this question, since the costs of getting a business valuation traditionally have been in the $5000 to $25,000 range. How much should an owner pay to find out