Business Valuation 101: The Five Myths of Valuing a Private Business

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As you work tirelessly to meet the everyday challenges of running your own business, you may wonder why you should be interested in a column on valuing your business. After all, valuation is something you will be concerned about some time in the future when there is "need" for a valuation. If you feel like this and you stop reading, you will be missing an opportunity to insure that your business will survive and prosper.

Understanding the factors that determine the value of any business will pay tangible dividends by focusing you on ways to increase your firm's short and long-run profitability. Moreover, if you choose to sell your business at some point in the future, this knowledge will assist you in positioning your company to receive the highest price. Therefore, there is no time like the present to begin to understand what a business valuation is, under what circumstances a valuation is customarily completed, and the critical issues to watch out for when events dictate that you undertake a business valuation.

What is a Business Valuation?
We first turn to the central issue—What is a business valuation? To answer this question, consider the following example. You own IBM stock and you want to know how much it is worth. Well, all you have to do is pick up the business section of the daily newspaper or go to any financial website, locate the stock tables and multiply IBM's closing price by the number of shares you own. Through this simple exercise, you have valued your IBM shares or what you would receive in cash if you sold your shares at the closing price.

In concept, valuing your private business is the same as valuing IBM stock. But, because your firm is private, there is no stock table that you can conveniently turn to. No need to worry, however, because there is a pseudo-science, or some say an art form, that provides the foundation for skilled business appraisers to estimate what your business is worth. The problem is that the valuation process is often viewed as a "black box." As a result, a whole mythology has grown up around valuation of private businesses. To help de-mystify the valuation process, let me introduce you to my top five myths about valuing a private business and explain how to avoid the pitfalls these myths present.

Top 5 Business Valuation Myths

Myth I: Valuing a private business should only be done when the business is ready to be sold or a lender requires a valuation as part of its due diligence process.
Although the business sales and lending processes generally require that valuations be completed, if these events represent the first time an owner has a valuation completed, then you can be sure critical business and estate planning issues have not been addressed. If the business is to have a life beyond that of its current owners, then effective planning for ownership transition requires a regular valuation of the business.

Ownership transition may include gifting some percentage of ownership shares to family members during the owner's life, thus reducing any tax on the owner's estate at death. If a firm has several owners, a buy-sell agreement with accompanying life insurance should be in place so that if an owner dies, the remaining owners have sufficient funds to purchase the deceased owner's interest at an agreed upon value. The buy-out value under these agreements should be updated regularly to reflect the firm's financial progress over time and the valuation approach used should be one of several acceptable to the IRS.

Myth II: Businesses in my industry always sell for two times annual revenue (the revenue multiple). So why should I pay someone to value my business?
The short answer is that data on selling prices indicate that revenue multiples within an industry are generally all over the lot. These rules of thumb used by business brokers, the individuals who often facilitate private business transactions, are median multiple values. The median value indicates that half of the revenue multiples are below the median value and half are above. Thus, the median value is just a convenient midpoint and does not represent the revenue multiple for any actual transaction. Unless the firm that is being valued is truly a median firm, then using the industry rule of thumb for this purpose is clearly wrong.

For example, according to a well- known source for business transaction data, Pratt's Stats, recent revenue multiples for firms in the auto parts industry ranged from a low of .98 to a high of 8.3 with a median of 2.9. If you were valuing your firm for sale and your annual revenue were $100,000, then the value of your business could be as low as $98,000, as high as $830,000, or somewhere in between. Where your firm lies along this continuum is obviously of the utmost importance and can only be determined by a valuation approach that incorporates academically validated methods with industry-specific valuation factors. Myth IV below discusses the legal and tax implications of assigning a value to your firm that is outside a permissible range.

Myth III: A local competitor sold his business for three times revenue six months ago. My business is worth at least this much!
Maybe yes and maybe no. What happened six months ago is not really relevant to what something is worth today. What your business is worth today depends on three factors: 1) how much cash it generates today; 2) expected growth in cash in the foreseeable future; and 3) the return buyers require on their investment in your business. First of all, unless your firm's cash flows and growth prospects are very similar to the competitor firm, that firm's revenue multiple is irrelevant to valuing your firm. Moreover, without getting into the nuances of finance, even if the competitor firm was equivalent to yours in every respect and both firms were sold today, if interest rates were higher today than 6 months ago, the firms would likely sell for less than three times revenue. Conversely, if rates were lower today than six months ago, the firms may be worth more than three times revenue. In short, the value of your business, like the value of IBM stock, is likely different today than six months ago because economic conditions have changed.

Myth IV: How much a business is worth depends on what the valuation is used for!
The value of a business is its fair market value (FMV). According to the Internal Revenue Service, the FMV is what a willing buyer will pay a willing seller when each is fully informed and under no pressure to act. While there may be a FMV range, the wider the assigned valuation range is, the less reliable is the valuation and the more likely it becomes that the valuation will face greater scrutiny from potential buyers or the IRS.

Consider the example of a parent selling a business to a child. The incentives to assign a low valuation under these circumstances are significant. Given that the parent pays taxes on the difference between the value of the stock sold to the child and its value on the firm's books (book value equity), establishing a low value on the firm's stock results in the parent minimizing the capital gains tax owed to the IRS. The child, on the other hand, has to come up with less money, because the sales price of the business is much lower than its FMV. These types of transactions are common and the IRS is always looking for abuses. Alternatively, an owner of a business may make a charitable contribution of company stock. In this case, there is a significant incentive to place the highest possible value on the donated shares, because this will result in the largest charitable tax deduction. If the value of the donated shares is outside the FMV range, an IRS audit may well be in the donor's future.

Myth V: Your business loses money, so it is not worth much.
Most private businesses appear to lose money. Appearances, however, are often misleading. Not long ago, a friend of mine was considering buying an auto parts business in California. The asking price was approximately $950,000 and, according to the firm's tax return, it hardly made a profit. Like many businesses of this type, this business was generating a great deal of cash, but this cash was masquerading as legitimate expenses. One expense category really stood out—payments to officers. This payment included the owner's wage of $80,000 per year and a bonus of $150,000 that the owner paid himself at the end of year. The $80,000 wage is what the business would have to pay a stranger to do the same job as the owner. This was a real expense. The $150,000, on the other hand, represents what finance people call a return to capital. It is the cash the business generated and it is this cash that determines the value of the business.

Unlike public companies, the separation between ownership and management does not really exist in a private firm. Thus owners have some discretion over how they categorize cash flow generated by the business. Quantifying the size of these discretionary expenses is often a critical determinant of the firm's value. As such, owners should keep a tab on what these discretionary expenses may be so that, when they are ready to sell the business, they can document these facts to the buyer. By doing so, the seller increases the buyer's confidence that the business does legitimately generate the cash the seller claims and, accordingly, increases the buyer's willingness to pay the asking price for the business.

In the final analysis, there are many important reasons that business owners should know the value of their businesses long before they decided to sell. By understanding the basics outlined above, you should be able to successfully plan the financial future of you and your family by understanding the value of your most important asset—your business.

Dr. Feldman is a co-founder and chairman of Axiom Valuation Solutions, which provides accurate, timely and cost-effective valuations of privately held businesses for business owners and their professional advisors. Dr. Feldman utilized his academic research and practical experience in the business valuation field to develop Axiom Valuation Solutions expert valuation system, the Valuation GURU. This expert system models all of the steps a valuation expert would take in conducting a valuation analysis, and integrates databases containing continually updated economic data for nearly 1,000 industries, to produce comprehensive, customized and objective valuation reports in nearly real-time. For further information on Axiom Valuation Solutions services, please call 800/477-8258, email info@axiomvaluation.comor visit www.axiomvaluation.com.