Business Valuation Basics: **Going Concern and Liquidation Value**

For the most part, the value of an asset or group of assets is the greater of its liquidation value or going concern value.

Value is the utility, worth or desirability of an asset, right or privilege. All things of value can be generically referred to as assets. In our society, assets are bought and sold with money (no offense to the barter folks). Therefore, value is expressed in dollars. The value that an asset has to any person or entity is simply the amount he or she is willing to pay to obtain it. A business is simply a group of assets.

Business valuation is the process of assigning a dollar value to a business by estimating what someone would pay to obtain the ownership rights. For the most part, an asset or group of assets has value only if it:

1. Can be sold and turned into cash, or

2. Generates cash.

The first is called liquidation value and the latter is called going concern value.

Going Concern Value

A business has value as a going concern only to the extent that it generates cash. If a business is to be operated as a going concern (i.e. its assets won't be liquidated), then its value is a function of the amount of cash or profit it will generate over time.

Liquidation Value

The amount of net cash obtained by selling the assets of a business piecemeal (not as a going concern) is liquidation value. "Net cash" means the sale proceeds minus expenses incurred in carrying out the sale. For example, the value of a parcel of real estate would be the price for which the asset could be sold, less any expenses of the sale such as commission, legal and closing fees.

Many assets don't generate income, such as a home that is lived in by its owner, or baseball cards, automobiles, furniture, equipment, etc. Assets, like these that don't generate income, have no going concern value … only liquidation value. The value of these assets is determined by the cash that could be generated from their liquidation.

Liquidation Value vs. Going Concern Value

It can be said that every business has two potential sources of values: liquidation value and going concern value. We use the term "potential" because a business does not necessarily have value of both types. For example, a business that consistently loses money may not have value as a going concern. Theoretically, such a business may have a negative going concern value. This is meaningless, however, because the owner of such a business would quickly liquidate the assets to eliminate the economic erosion. The value received would be the liquidation value, or the sale price less sales expenses.

It is important to mention, however, that a business that is losing money COULD sell as a going concern (i.e. for more than its liquidation value). This would only occur if a buyer believed it could operate the business profitably as a going concern. For the seller to obtain a price exceeding what could be obtained via liquidation, this buyer would have to be willing and able to pay more than the liquidation value. This would mean the buyer was willing and able to pay the seller for value the buyer brings to the business because of the buyer's skills, abilities, assets or competencies. Often, shrewd buyers will not do this unless they are worried that a competing buyer might purchase the business or group of assets for a price greater than liquidation value.

The concepts of going concern value and liquidation value can also lead to interesting predicaments. For example, consider a business that has assets that could be liquidated (i.e. "sold off" individually) for $2 million but generates only $100,000 per year in profits. What is the value of this business? If the assets of the business are to be sold-off, the value is clearly $2 million. If the business will not be liquidated, then the value is simply the income stream it generates.

So, what is the value of a $100,000 annual income stream? The answer depends on: 1) certainty with which the $100,000 will be received in the future (risk), and 2) value today of dollars received in the future (time value of money). Both of these topics will be covered in the upcoming May/June issue of *The Business Owner*.