How <u>NOT</u> to Value a Business

Both buyers and sellers need to be wary of naive business valuation generalizations. As the old adage goes, if it's too good to be true, it usually is. This is often the case with rules of thumb that are easy to remember and use, but frequently lead to misguided conclusions.

In a recent issue of a newsletter published by a well-respected industry association, a small sidebar article appeared that was titled, “Putting a Price Tag on your Company.” The article was only seven sentences long and a perfect example of how not to value a business. If the advice was taken at face value, it would often result in an inaccurate or unrealistic value conclusion.

Here is why:

Let’s value two hypothetical companies by the methods suggested in the article.

Company A- Revenues: $10 million Three-Year Average Profits: $2 million Liquidation value of assets: $500,000

Company B- Revenues: $10 million Three-Year Average Profits: $0 (zero!) Liquidation value of assets: $2,000,000

The article suggests that you can calculate value as a standard percent of revenue … usually 50 to 80 percent. However, if we use 75 percent, both Company A and Company B are worth $7.5 million, regardless of their profitability or growth potential! Rather doubtful.

This formula doesn’t take into account industry. It does not take into account the company type, such as manufacturing, distribution, retail or technology.

The article states that companies with higher investment in their plants and equipment usually merit higher multiples. That certainly is not always the case. More important is the productivity of the assets and profitability of the business.

The article goes on to suggest a second valuation method: “Unless your company has high reinvestment costs (such as R&D), five times a three-year average of profits is a justifiable valuation.” Using our two hypothetical companies again, Company A would be worth $10 million, not $7.5 million; and Company B would be worth absolutely nothing, not the $7.5 million as suggested by their multiple of revenue method But then again, by profits do they mean gross profit, net profit, E.B.I.T., E.B.I.T.D.A., or some other adjusted figure?

An important consideration not mentioned at all is deal structure, commonly referred to as “terms.” Are we talking 100 percent of the purchase price paid in cash at closing, or no money at closing and the price paid in equal installments over ten years? Is it based on an asset sale or a stock sale? These things can drastically influence price.

The article’s third suggestion: “A simple way to know your worth is to compare your company to a publicly traded one.” Well, it’s just not that simple. To what public company are you going to compare? What correlation and validity will it really render? Is there any usefulness in this exercise unless the companies are of comparable size? Comparable growth rates? What about

access to capital and liquidity of the shares? Attempting to use this method haphazardly can lead to results that are seriously flawed.

Consider what would be an extreme example … a local, single location, non-franchised hamburger stand to that of the corporate stock of McDonald's. The problems in attempting to do so are obviously overwhelming.

To treat the valuation of a privately held or closely held company in a flippant or casual manner does a great injustice. If a company owner is contemplating the sale or purchase of a business, it is likely one of the most important financial transactions of his or her life. Competent and professional advice is needed.

It is not unusual for a business owner, in a conversation with his or her attorney or CPA, to pressure for an off-the-cuff value of his or her business. This is unfair to both parties. Attorneys and CPA's are an essential ingredient in the process of selling or buying a business, especially for legal and tax issues. However, unless they specialize in business transfers and business valuations, they shouldn't be pressed to provide expertise in an area that they don't have specific experience or training. In addition, what many people don't realize, to quote Dr. Shannon P. Pratt in Valuing a Business, "There is nothing in the uniform CPA examination that addresses the subject of business appraisal." The same goes for the Bar exam.

When valuing a business, make sure that whomever you choose is qualified for the job. Clearly, this means a person that has specific training in the valuation of businesses the size of your own. A compelling case can be made as well for choosing a person that, in addition to valuing businesses, actively consults in the purchase and sale of such companies. Common sense would say that such a person would have a better understanding of the price and terms for which companies are really selling.

Because these issues are so important, business owners would also be well served by developing their own basic understanding of business valuation. They can use the knowledge to check the work of others for reasonableness and to avoid wasting time and money. Articles in this publication will periodically review these basic concepts.

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