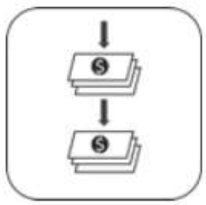
White Paper
Valuation -- Do You Know What Your Company is Worth?

Overview

The decision to sell your business has a huge potential impact on your financial situation, your current employees, and the growth prospects for your business after the sale. But before you can sell your business it's important to place a value on it so that you and the buyer can agree on a purchase price.

There are three approaches used by accounting and finance professionals to value a business.


Asset Approach


Financial Approach


Market Approach

Asset Approach

The Asset Approach values a business by assigning a value to the assets and liabilities from the Company's balance sheet and uses those values to compute the firm's equity. This approach is based on the balance sheet formula; Assets minus Liabilities equals Equity. This means that the Company's equity is the value of the business.

Certified Public Accountants (CPAs) use Generally Accepted Accounting Principles (GAAP) and these principles state that most assets are to be valued at original cost less depreciation. However there are some costs incurred by the business that generate company value that are not posted to the balance sheet as assets.

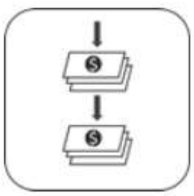
Some of these items might include; machinery, buildings, patents and licenses to name a few. It's important to work with your CPA firm and Investment Banker to gain an understanding of these concepts and intangible assets.

Assume, for example, that Mountaintop Tree & Landscaping is a tree service and landscaping business generating $20 million in annual sales. Mountaintop has customers in older neighborhoods whose large trees must be removed from tight spaces between homes as well as higher elevation clients that have special access requirements. The firm had to design and build special equipment and technology to safely remove these trees to service its broad customer base but much of the cost to develop this equipment was expensed as research & development cost.

As a result, the assets on the company's balance sheet do not reflect the true value of the equipment and how that equipment and technology drives sales. A buyer looking to acquire Mountaintop who knows the industry may realize the true value of this equipment and technology and will be willing to pay more for the company. This is an example of one type of adjustment that can be made to the balance sheet for a company valuation.

Help buyers discover your company's true value by working with a CPA firm, or other trusted financial advisor, that specializes in valuation. An Investment Banker can provide you with insight as to what characteristics your market and potential buyers will value.

Financial Approach



The Financial Approach considers the future financial performance and cash flows that the business will generate. These are the key metrics that generally determine how a buyer will recover their original investment and earn a profit from the purchase of the company.

Using the Mountaintop Tree & Landscaping Service example, assume that the business generates $2 million in annual earnings on $20 million in sales each year. The company is expected to grow earnings by 5% each year, which means that the company will earn $2,1050,000 in year two, and more each year after that.

To determine the value of the company today, the buyer can apply a discount rate to the future cash flows of the firm. The discount rate is applied to each of the future cash flows to adjust the payments to present value. The sum of all the present value cash inflows is the value of the company today.

The Financial approach is similar to the valuation process for stocks because a company's projected earnings per share (EPS) is compared to the market price of the stock using the price/earnings (P/E) ratio. If the market price of a share of stock is $100 and the EPS is $10, then the P/E ratio is $100 divided by $10, or 10 times earnings.

If the earnings of a company increase, the P/E ratio will decline. That means the stock is "cheaper" as a multiple of earnings. The P/E ratio tells an investor how much they are paying for each dollar of earnings. It is the same case with the Income Approach for a company valuation – a reference to what the buyer is really buying --- a flow of company earnings.

The Financial Approach applies a discount rate to future company earnings. Companies that show steady growth may discover more value from using this method.

Market Approach

The Market Approach considers how buyers and sellers value businesses in the same industry. That method is considered as standard valuation when assigning a price to a business that is for sale. The Market Approach may result in a sale price that is far above the total equity on the company's balance sheet because the buyer assumes there are unique advantages that make the business more valuable. This "excess" value is classified as Goodwill post transaction.

This approach is commonly used to value companies in the technology sector. Assume, for example, that New Spark is a technology firm that helps companies place advertisements on Facebook. The business is two years old and generates $12 million in annual revenue with a small profit of $500,000. Because of Facebook's dominant position in the online advertising market potential buyers are willing to pay 20-times earnings for companies in this industry, or $10 million in the case of New Spark.

While that price seems like an unusually high valuation, a buyer believes that this type of business will grow rapidly and will generate huge increases in sales and profit. Think about past financial performance as a foundation to build (and sell) the future financial performance which is what drives valuations.

There ae many market factors that can affect the market valuation of your company. When using the Market Approach it is important to understand these factors that unlock your company's true value. Consulting with industry experts can help you with this process.

Other Factors that Add Value to a Business

There are other factors that add to the value of a business that you and the buyer should consider. These factors are not stated in financial statements.

Experienced Management Team

One reason why businesses are successful is because the management team uses their experience to make smart decisions. If there is an experienced management team that works well together, then that situation can have value. The buyer of a company with an experienced management team can provide financial incentives to keep them in place so the company can continue to grow sales and earnings.

Documented Procedures

Every successful business has a method of performing routine tasks, such as shipping a product or billing their clients. These business operations procedures have value because these methods save time, minimize expenses and serve the company's customers. If a company has documented all your routine procedures and you maintain procedures manual, a potential buyer will have a clearer understanding of how to operate the business going forward.

Recurring Revenue/Customer Diversity

A company may have repeat customers; those who purchase your products or services every month. This scenario reduces the need to spend marketing and sales dollars to find new business. In addition, recurring revenue also makes it much easier to generate sufficient cash inflows to operate the business each month.

Buyers look for businesses that have multiple customers. They typically prefer businesses where no one single customer accounts for than 10% to 15% of the company's total sales. Customer diversity helps protect against revenue loss if a given customer stops making their usual purchases. Both Recurring Revenue and Customer Diversity reduce the revenue stream risk and the corresponding discount factor applied to future cashflows thereby increasing company overall value.

Summary

These approaches and factors are just some examples of characteristics that may add to the value of a business. Both buyers and sellers have reasons to motivate them to complete a sale. If a seller wishes to sell a business urgently, for example, that seller may accept a lower price or modified structure to close the deal quickly. The seller may have a financial need for the sale proceeds, or he/she may wish to exit the business for personal or lifestyle reasons.

In other cases, a competitor may see a unique opportunity to acquire a business and operate the combined firm to grow total sales. In this scenario a buyer may be willing to pay a higher price for a business given the strategic synergies to quickly increase scale or to make the most of a new competitive advantage.

No matter what the reason for selling a business, it is important to recognize that this is a complex and important decision that requires commitment to a dedicated process. The idea of selling a business can raise a great number of questions as well as cause anxiety. By working with trusted financial advisors who can explain these valuation methods and factors in more detail, you will be closer to discovering the true value of your business.

For more information on how to value a company in preparation for a sale please contact John at 702-463-0332 or via e-mail at john.illes@illesinvestmentbanking.com.

This paper was written by the team at Merit Harbor Capital and used by permission. John Illes, Principle of Illes Investment Banking is also Managing Director with Merit Harbor Capital.