

Daily Commerce

• Since 1917 •

Vol. 73 — No. 140 • Los Angeles, California

Tuesday Evening, July 15, 1986

Is Business Valuation an Art, A Science or Pure Guess Work?



A Los Angeles business leader speaks out on a problem facing privately owned "middle market" companies.

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Judged by either public attitudes or hard economic statistics, "middle market" companies have taken on increased importance in recent years and have been recognized as valuable sources of innovation and economic growth in the United States.

Signs of revitalization and renewed interest are apparent throughout the economy with the rapidly changing business environment providing a multitude of opportunities for increased business activity. Shifting public attitudes, economic change and technological advances have all contributed to the sector's growth. In addition, a political and philosophical swing away from government regulation and toward free enterprise has also benefited many parts of this sector.

Principally, "middle market" companies are usually considered to be companies with less than 100 employees and revenues in the \$1 to \$50 million range. For the most part, they are privately owned businesses and are therefore not publicly traded on one of the stock exchanges.

California traditionally has been a land of opportunity for this sector, having far more "middle market" companies than any other state in the nation. California heads the list of states with the fastest growing companies in the nation accounting for 86 of Inc.'s 1985 list of the 500 most dynamic private firms in the nation. A vigorous and diverse economy accounts for much of the state's allure, with both a strong manufacturing and

services sector offering a wide range of opportunity. This broad economic base traditionally has buffered the state from the full effects of U.S. economic slumps.

Consequently, it is not surprising that for 1986, all indications point to a very active merger and acquisition market in California, as a result of series of favorable economic trends, the state's pro-business climate, its proximity to the Pacific Rim and the vast number of businesses comprising this segment of the market. Newspaper headlines continue to be dominated by the news of megabuck mergers; however, the vast majority of today's merger and acquisition activity is comprised of transactions involving privately owned, closely held middle - market companies.

It is extremely difficult to measure the size of the market because of its very nature - private. However, industry estimates indicate that transactions involving middle market companies will exceed 15,000 nationwide in 1986, with approximately 22 percent of the transactions occurring over 1985.

Now more than ever, owners of privately held middle market companies are being confronted with need to establish a value for their businesses for a variety of reasons: (1) sale of part or the entire business, (2) buying out a partner, (3) tax planning, (4) insurance coverage, (5) bank loans, (6) employee stock ownership plans, (7) estate planning (8) divorce and (9) death. The task is not easy and can be very complex depending on the circumstances at hand. The problem is compounded by the many different methods of valuation, with no single solution covering every business.

A privately owned, closely held company, by definition, is one whose shares are owned by a limited number of stockholders. Quite often, they are officers and directors of the company, and in many cases, ownership is held within one family. Therefore, the traditional marketplace of a "willing buyer" and a "willing seller" provided by the public securities markets is not available to establish a value for the company's stock.

In addition, owners of privately held companies will typically have done everything legally possible to suppress profits to minimize taxes, unlike public companies which seek to maximize earnings. As a result, it is even more difficult to place a realistic valuation on a privately held business. The problem is further exacerbated by the fact that, unlike publicly traded companies, very few privately held companies have audited financial statements, thereby making an objective evaluation of the financial statements a far more complex task and the result less credible.

Recently, owners of privately held middle market companies have begun to recognize the

need for a professional approach to the valuation of their companies in order to overcome the lack of the "willing buyer-willing seller" marketplace. As the same time, many of the more simplistic methods of valuation are giving way to more sophisticated techniques that take into consideration the many complexities of the modern business world.

It is often said that determining the value of a privately held business is, at best, an art as much as a science and, at worst, a pure guess. To say the least, there are probably more methods used to determine the value of a business than there are ways "to skin the proverbial cat." Valuing a business requires an extensive process of information gathering and analyzing which, along the way, incorporates substantial judgmental factors. The following are some of the more common and widely used methods of business valuation:

1. Market Comparison
2. Discounted Cash Flow
3. Orderly Liquidation
4. Adjusted Net Worth
5. Replacement Value
6. Multiple of Book Value
7. Multiple of Revenues
8. Multiple of Earnings
9. Contribution Margin
10. Tangible Assets/Capitalized Income (Excess earnings)

No matter which approach is used, the most difficult issue is determining the value of goodwill, as it is entirely subjective. Goodwill usually represents a major portion of a business' valuation, and ultimately affects the price of the business. It can change radically from period to period, and hinges on dozens of variables. Goodwill has often been described as those attributes of a business that enable the business to generate a profit which exceeds the return that might normally be expected from assets employed by the company. It consists principally of the intangible assets of a business such as reputation, history, customer base, trademarks, franchises, trained employees, patents, etc. - elements that have contributed to the success of the business but are not reflected in the financial statements of the business. These intangible assets must be included in the valuation to properly determine a business' "true" value. Goodwill is a distinct part of any business acquisition, and a prospective buyer must understand its concept before serious negotiations can commence.

The determination of an absolute value of goodwill is difficult of not impossible to determine; however, one of the approaches to valuation, the tangible assets/capitalized income approach ("excess earnings") is often considered the most appropriate method as it best identifies those

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earnings of a business attributable to goodwill. It is one of the most widely used methods and has a great deal of support as being one of the most appropriate methods to value a business. In addition, should a dispute with the Internal Revenue Service arise over the valuation of goodwill, it is usually this method, or a variation thereof, that will be used in the determination. Further, it is extremely important that this concept be understood as it is derived from the theory that goodwill creates excess earnings which, in turn, increases the value of a business. Utilizing this method, excess earnings are thereby isolated and valued.

The following outlines the application of this method:

1) Calculate the average -tangible net assets for the past five years.

2) Multiply the rate of return, which an investor could reasonable expect to earn, by the average tangible net assets. A reasonable rate of return would be one that an investor could obtain in today's second trust deed market - approximately 12¹/₂ percent, which reflects a "risk premium" over and above the "risk free" rate.

3) Calculate the average pretax earnings for the past five years. Adjustment should be made for any unusual variations.

4) Subtract the amount calculated in No. 2 above

from the average pretax earnings. The amount of earnings remaining is considered attributable to goodwill.

5) Apply, to the amount determined in No. 4 above, a capitalization rate to calculate the value of goodwill.

NOTE: Goodwill is intangible and extremely perishable, it needs a multitude of factors to maintain it; therefore, due to its fragile nature, an investor would want a return at least twice that of the return on the business' net tangible assets, in this case 25 percent.

6) Add the result obtained in No. 5 to the business' tangible net worth to determine the total value.

The following example illustrates the foregoing: Let us assume, that X Company has average total assets of \$750,000, intangible assets of \$50,000 average pretax earnings of \$187,500, and tangible net worth of \$500,000.

Then you would calculate that average tangible net assets as \$750,000 minus \$50,000 or \$700,000. Earnings attributable to average tangible net assets would be 12.5 percent times \$700,000, or \$87,500. Excess earnings, those attributable to goodwill would be \$100,000 (\$187,500 less \$87,000). The value of goodwill would be \$400,000 (\$100,000 divided by 25 percent). Finally, the total value

would be \$900,000, the sum of tangible net worth (\$500,000) and goodwill (\$400,000).

Revenue Ruling No 59-60 of the Internal Revenue Service indicates that for there to be a sound valuation, all of the relevant facts, and the rule of reason, should be considered in establishing a value for a given business. There are a multitude of factors, both positive and negative, that can affect the value of goodwill, all of which must be given adequate consideration and evaluation in determining the value of a business.

There is no one single formula that exists for the determination of a business' value since the methodology depends on the situation. Valuation at its best somewhat less precise than everyone would like. However, after a study of all relevant facts, the application of a sound methodology and an informed judgment that reflects reasonableness, as well as common sense, will result in a valid conclusion.

Notwithstanding all of the foregoing, in the final analysis, the ultimate test of the true value of a business will be determined by the marketplace. It has often been said that beauty is in the eyes of the beholder, similarly, true value is in the eye of the buyer.



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