

Daily News

Monday, April 28, 1986

Privately owned firms elude simple valuation

Increasing number of acquisitions creates need to assess worth without traditional references

In Perspectives, a Los Angeles Business leader discusses an issue of public concern. This week's columnist is Franz von Bradsky, president of Green Tree Capital in North Hollywood.

By FRANZ von BRADSKY

All indications point to an extremely active merger and acquisition market in 1986, particularly in Southern California – the result of a series of favorable economic trends such the state's pro-business climate and its proximity to the Pacific Rim. While the headlines continue to be dominated by the news of megabuck mergers, the vast majority of today's merger and acquisition activity is composed of transactions involving privately owned, closely held "middle market" companies whose annual revenues are in the \$1 million to \$50 million range.

Measuring the size of the market is difficult because of its very nature – private. However, estimates from sources in the industry indicate that transactions involving "middle market" companies will number 7,000 to 10,000 nationwide in 1986, with between 20 percent and 24 percent of the transactions occurring in California.

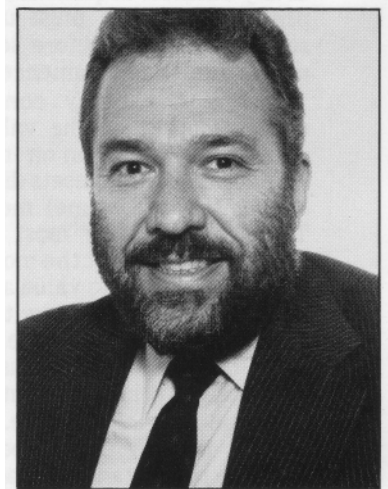
Owners of privately held companies are confronted with the need to establish a value for their business for a variety of reasons: sale of the business, buying out a partner, estate and tax planning, insurance coverage, bank loans, employee stock ownership plans, divorce or death. The task is not easy. The problem is compounded by the many different

methods of valuation, with no single solution covering every business.

By definition, a privately owned, closely held company is an entity whose shares are owned by a limited number of stockholders. More often than not, they are officers and directors of the company, and in many cases, ownership is held within one family. Therefore, the traditional market of a "willing buyer" and a "willing seller" cannot be used to establish a value for the company's stock, as it does not exist.

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

Consequently, owners, managers and advisers to privately held "middle market" companies recognize the need for professional valuations of their companies in order to overcome the lack of the "willing buyer-willing seller" market. Concomitantly, many of the more simplistic methods are giving way to more sophisticated techniques that take into consideration the many complexities of the modern business world with its ever-increasing amount of governmental regulation.



Franz von Bradsky, the president of Green Tree Capital in North Hollywood, will lead a seminar May 2 on buying and merging firms.

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. Perhaps the most difficult aspect is determining the value of "goodwill." Usually, it represents a major portion of the valuation and ultimately affects the price of the business. It can change radically from period to period and hinges on dozens of variables. Goodwill principally consists of the intangible assets of a business such as reputation, history, customer base, trademarks, franchises, trained employees and patents – 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

Valuing private companies takes more than guessing

valuation to properly determine a business's "true" value. Goodwill is a distinct part of any business acquisition, and a prospective buyer must understand its concept before serious negotiations can commence.

Among the many concepts used to determine the value of goodwill is the return on investment (net tangible assets divided by the capitalized income) method. This is one of the most often used methods, if not the most appropriate method to value a business. Should a dispute with the government arise over the valuation of goodwill, it is usually this method that the Internal Revenue Service will use. Further, it is extremely important that one understand this method as it is derived from the concept that goodwill creates excess earnings which, in turn, increase the value of a business. This method isolates the excess earnings and values it. The method is applied as follows:

1. Calculate the average tangible net assets for the past five years.
2. Apply a rate of return, which an investor could reasonably expect to earn, to the average tangible net assets.
3. Calculate the average pretax earnings for the past five years.

4. Deduct the amount calculated in step 2 from the average pretax earnings. The remainder is the earnings attributed to goodwill.

5. Apply to the amount determined in step 4 a capitalization rate to calculate the value of goodwill.

6. Note: Goodwill is intangible and perishable, it needs a multitude of factors to maintain it; therefore, due to its fragile nature, an investor would want a return on the business's net tangible assets.

7. Add the result of step 5 to the business's tangible net worth to determine the total value.

Assume, for example, X Co. has average total assets of \$675,000, intangible assets of \$50,000, average pretax earnings of \$175,000, tangible net worth of \$383,333, a rate of return of 12 percent and a capitalization rate for goodwill of 24 percent. (A reasonably good rate of return would be what an investor could get in today's second trust deed market).

Then you could calculate that average tangible net assets are \$675,000 minus \$50,000 or \$625,000. Earnings attributable to average tangible net assets would be 12 percent times \$625,000, or \$75,000. Earnings attributed to goodwill would be \$175,000 minus \$75,000, or \$100,000. The value of goodwill would

be \$100,000 divided by 24 percent, or \$416,667. Total value would be \$383,333 plus \$416,667 or \$800,000.

The Internal Revenue Service's Ruling 59-60 states that for a sound valuation, all relevant facts, and the rule of reason, should be considered in establishing a value for 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.

No single formula exists for the determination of a business's value since the methodology depends on the situation. Valuation at its best is a subjective-objective process. A valid conclusion should be based on a study of all relevant facts, application of sound methodology that reflects common sense, informed judgment and reasonableness – all of which are essential elements in the process.

Notwithstanding all of the foregoing, in the final analysis, the ultimate test of the true value of a business will be determined by the market. 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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