

# **BUSINESS VALUATION: 5 REASONS WHY IT'S IMPORTANT**

WHITE PAPER



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# Introduction

Few business owners relish spending money on something unnecessary. For most owners, hiring an expert to estimate the value of their companies falls into the *unnecessary* category. Thus, it is no surprise that owners typically respond to an Exit Planning Advisor's recommendation to get an estimate of value for the company with some variation of, "Now? But I'm not planning to leave for years," or "I built this company, so I know what it is worth better than any so-called expert."

Before you join these owners and scratch *business valuation* off of your Exit Planning to-do list, consider the following five reasons why you should put an estimate of value at the top of your list. An estimate of value does the following:

1. Establishes your starting line and distance to the finish.
2. Tests your Exit Objectives.
3. Provides important tax information.
4. Gives you a critical litmus test.
5. Provides owners (and employees) an objective basis for incentive plans.

The following list sums up some key aspects about estimates of value.

- They are not a full-blown opinion of value, which you will need just prior to your transfer of ownership.
- They cost about half as much as a standard opinion of value because they lack the supporting information contained in a standard opinion of value.
- They are the basis for the complete valuation to be completed later.

- They are used for planning purposes only. They cannot be relied on for tax or other purposes.

Let's examine the reasons why an estimate of value is a tool you must include in your Exit Planning tool kit.

## Reason 1: Establishes Your Starting Line and Distance to the Finish

To create Exit Plans for owners, we use The BEI Seven Step Exit Planning Process™, which is based on each owner's unique objectives. The three primary objectives that owners set are as follows:

1. The date they wish to exit.
2. The amount of cash they need from the transfer/sale of their companies to ensure a comfortable post-exit life.
3. Their choice of successor (the party they wish to sell or transfer to).

In the course of achieving these objectives, most owners want to receive full, fair value for their companies or ownership interest.

Few owners are comfortable relying on averages, rules of thumb, or informal or casual estimates. These measurements rarely take into account variations in revenue, cash flow, location, reputation, proprietary technology, contingent liabilities, and many other factors that can have a significant effect on the value of a particular business. So, how else do you determine your starting point (i.e., today's value) without the estimate of an experienced, trained business-valuation specialist?

If you subscribe to the belief that it's not where you start, it's where you finish that's important, you'll agree that it is in your best interest to know how far you must go to reach your finish line. In Exit Planning, your finish line is the amount of cash you need from your company on the day that you sell or transfer it.

If neither your starting point nor the distance to the finish interest you, ask yourself this question: Do you think a sophisticated buyer will acquire your business without first determining its worth? No qualified buyer will do so. Thus, we strongly recommend that you not sell or transfer your business to anyone without *first* determining its worth.

## **Reason 2: Test Your Exit Objectives**

As stated earlier, one of the first questions you'll answer as you set your Exit Objectives is, "How much will I need from the sale of my company to maintain the lifestyle I want for myself (and my family) in retirement?" The companion question should be, "Is the business worth enough (on an after-tax basis) to support those needs?" You must know this answer before you can successfully proceed down any Exit Path.

Let's assume that you decide that your finish line (financial objective) is to receive \$7 million (after taxes) from the transfer of your business interest. You also want to complete your race in three years (timing objective). An estimate of value will tell you whether the distance between today's value and the finish line is too great to reach in three years. If a

growth rate is unrealistic for your business, you must either extend your timeline or lower your financial expectations.

## **Reason 3: Basis for Tax Planning**

As you consider various Exit Paths (e.g., sale to a third party or a transfer to insiders), understand that each Path has different tax implications. Without appropriate tax planning, taxes can take a huge bite out of your sale proceeds.

For example, in a transfer to key employees, a common transfer technique (designed to reduce both the owner's and buyer's tax liabilities) is to initially transfer a minority interest at a discounted value. Using a rule-of-thumb valuation to support a minority discount simply will not fly when the IRS asks you to justify the discount. You must depend on the valuation of an independent valuation specialist who is able and willing to defend the valuation before the IRS.

Given that tax-mitigation strategies often take years to implement, it is critical that you start planning well before you exit and that you use an accurate estimate of value.

## **Reason 4: Litmus Test**

Suppose an owner is ready to leave the business, but only if that exit yields financial security. That owner must calculate the amount of cash needed to assure financial security and subtract the value of the business today from that number. The resulting gap tells the owner how much value he or she needs to create to meet his or her objectives. It also shows where

he or she needs to concentrate his or her time and effort. Instead of growing value just for fun, dedication to a goal enables many owners to exit sooner and with the same amount of after-tax cash than owners who do little or no planning. Exit Plan success always begins with a starting value. Let's look at two other factors that determine the accuracy of your litmus test.

## **Target Buyer**

It surprises many owners to learn that business value is relative, not fixed. It can vary based on the owner's choice of successor or the conditions under which a transfer is made. For example, an appropriate business value for a third-party sale may be significantly higher than the value established for a transfer of the same business to key employees over time or the value of a gift of the business to children. Business-valuation experts understand this; rules of thumb don't.

If you are contemplating a sale to a third party, the business value is dependent on not only the intrinsic value of the business but also the "external" condition of the mergers and acquisitions (M&A) market for that type of business in that particular geographic area. The M&A cycle is continually changing based on a variety of factors, such as the cost of financing, the state of the stock market, and the availability of capital. The market can dictate not only your EBITDA (earnings before interest, tax, depreciation, and amortization) multiple but also the terms of a possible third-party deal (e.g., how much of the deal price is to be paid in cash, a seller carry-back note, or earn-outs).

## **Buy-Sell Agreement**

Value is not only relative based on successor choice; it also fluctuates depending on how the owner plans to use the valuation. In co-owned companies, unless owners periodically update the business value established in their buy-sell agreement, one owner may receive too much or too little upon death, disability, or departure while the other may pay too much or too little. Outdated valuations often result in litigation (and subsequent loss of business value), as the slighted owner often chooses to go to court.

## **Reason 5: Provides Owners (and Employees) an Objective Basis for Incentive Plans**

An important part of any Exit Plan is to grow business value. Whether you contemplate a transfer to insiders or a sale to outsiders, you must motivate and keep your management/key employees within the company.

To keep key employees from exiting with them, owners use incentive programs that both motivate and "handcuff" employees to a company. These plans are typically based on formulas, and the most successful of these incentive programs (whether cash- or stock-based) use formulas that link the size of a bonus to growth in business value.

Participating employees are justifiably interested in knowing how the business' value was established, how it is measured, and

whether the value is fair. Relying on an outside appraiser is often the best way to dispel management/key employee concerns.

If you are considering a transfer to key employees, do you expect your employees to accept an unsupported valuation? Understand that they likely have little sense for what the business is worth or how its value should be determined. Even though you may decide to sell the business at a low value (for tax and other reasons), employees may not consider the “low” value to be low to them. Anticipate these concerns and use an independent valuation to allay them.

## Cost

The cost of an estimate of value can range from \$0 to \$25,000, depending on who performs the valuation. If you use a free online valuation software, it may be free. If you use transaction intermediaries, non-certified advisors, or certified business appraisers, the cost can fluctuate depending on, among other factors, the level of expertise you seek. The cost for an estimate of value can also reflect the complexity of the business and the region of the country in which your company does business.

For a “normal” business with \$10 million or so in revenue, a valuation typically costs \$5,000–15,000, and an estimate of value costs 60–75% of that amount. When the value calculation is upgraded (usually just prior to the sale), the valuator will likely charge an additional 25%.

With many experts clamoring for your business, who should you use? Look for a **credentialed valuation expert**, unless you own a very small business that has no proprietary technology, such as a small retail

store, franchise restaurant, or service business with only a few employees. Common certification designations include certified valuation analyst (CVA), American Society of Appraisers (ASA), accredited in business valuation (ABV), and certified business appraiser (CBA).

## Failure to Value

The cost of a valuation may seem too high or just plain unnecessary at first glance. However, compare it to the cost of the following:

1. Leaving money on the closing table because you underestimated the company’s value.
2. Appearing before the IRS to defend a rule-of-thumb value that is unprotected by a proper valuation.

An estimate of value at the outset of planning helps you target your value-building efforts and move efficiently toward a goal. Don’t let the initial costs frighten you, because the costs of failing to obtain an accurate valuation can make the initial costs look like pocket change.

## Conclusion

At some level, we all recognize that we will leave our businesses some day. While you may not yet have a vision for your life after the business, you do understand that your exit from your business is likely to be the largest, most important financial transaction of your life. Does it make sense to go into that transaction and life after business without an objective understanding of your company’s value? We

don't think so, and we'd like to help you plan for the most important financial decision of your life today.

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