

ARE BUSINESS VALUATIONS REALLY NECESSARY?

WHITE PAPER



Ryan Staton, MBA, AIF®, CFP®, CExP™, ChFC®
StatonWalsh
729 S Conkling St
Baltimore , MD 21224
Phone: 410-777-9487
[StatonWalsh](#)

When we suggest to our business owner clients that they secure a business valuation, we hear one or more of the following, sometimes-valid objections:

- **Cost:** “Valuations are too expensive. They cost \$15k or more.”
- **Relevance:** “I already know what my business is worth.”
- **Timing:** “I don’t need a valuation until I’m ready to sell.”

This white paper discusses several business valuation methods (and costs, if any) and explains why and when accurate valuations are essential.

When you finish reading this white paper, you will be better prepared to select the valuation method, if any, that is most appropriate to your situation.

THE MULTIPLE USES OF BUSINESS VALUATIONS

Owners need accurate business valuations:1) before they sell or transfer their ownership to third parties or insiders, or 2) to establish benchmarks and goals when growing business value. We discuss both in this section of this white paper.

Valuations before a sale or transfer of ownership are used:

- To determine the likely sale price of their business.
- To understand with accuracy the value of their ownership interest if selling or transferring to children or key employees.

- To determine the existence and size of the gap between the financial resources they have and the resources they’ll need to live the lives they want after they leave their companies.
- To estimate the tax consequences of the ownership transfer to you.

Whether you contemplate leaving your company years from now or in the next few months, you and your advisors must know, with a reasonable degree of certainty, the value of your business because your business is likely your largest asset.

Owners also use valuations to set benchmarks for key employees participating in incentive plans. Benchmarks are typically a set percentage of growth in value of the business, such as 10% each year. Consequently, it’s important both for owners and participating employees to have an accurate and agreed-upon means of measuring growth in value.

Valuations Before a Sale of Ownership to a Third Party

Let’s look at how fictional owner, Brian Alpert, responded when his advisor recommended a business valuation.

Thomas Ryder was a bit taken aback when his client, Brian Alpert, announced at their annual year-end meeting, “I’ve decided to sell my business.”

“Really!” was Thomas’ initial reply. “Tell me more.”

“Well, my business is worth around \$6 million,” Brian explained. “I can sell it and net almost \$5 million. That and my \$1 million in investments will give my wife and me plenty

to live on. I can keep you informed as the deal progresses, but at this point, all I need from you is the name of an attorney to draft the papers once I'm ready to move forward."

Tom said, "Can I ask how you determined that your business is worth \$6 million?"

"I've been keeping track of EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) multiples in my industry as well as reading what the M&A market is doing," Brian said. "It seems like a six multiple is appropriate and our EBITDA this year will be almost \$1 million."

After years of working with Brian, Tom suspected that Brian's multiple was too high, and that his business was worth significantly less than \$6 million.

Putting a company on the market is both costly and time consuming, but in Brian's case, it would likely end in failure because Brian had successfully resisted all of Tom's efforts to diversify the company's customer base. Even if a buyer could accept the company's dependence on three customers, if it failed to offer what Brian thinks his company is worth, Brian would have wasted time and tens of thousands of dollars in legal, accounting, and investment banking fees, and tainted the marketplace. (Buyers seldom want to take a second look at a business they've already rejected.)

"Can I suggest that we get a more definitive understanding of the value of your business before you move forward?" Tom asked.

"I don't think so," Brian responded. "I just don't want to spend \$15,000 to \$20,000."

"I see your point," Tom agreed. "But you don't have to spend that kind of money to get a good idea of the value of your business for sale purposes. "I strongly recommend that we secure the type of valuation you must have to make an informed decision about the sale price of your company. I know we can do that for far less than \$15,000."

Brian leaned forward, "Really? Now it's your turn to tell me more!"

Tom would have recommended some type of valuation even if Brian planned to sell his company to a child, co-owner(s), or key employee(s). Tom understood, as we do, that valuations are critical regardless of the type of successor you choose and should be performed according to the date you plan to begin the transfer of your ownership.

The Underappreciated Role of Net Proceeds

Brian's advisor knew from experience that many owners focus exclusively on top-line price, so Tom knew he needed to address the issue of net proceeds with Brian during a subsequent phone call.

"Brian," Tom started, "while you are thinking about getting a professional valuation, I want you to also think about the net proceeds from the sale rather than just the sale price."

"Okay," said Brian before asking, "but why now?"

Tom said, "Unless your personal investments and the net proceeds from the transfer of your business are adequate, you won't be able to exit your business, or if you

do, you will not be able to provide financial security to your family, and some of your other goals may be unattainable. In fact, in worst-case scenarios, owners are forced to return to work after the sale of their companies to provide for themselves and their families.”

There was a long pause before Brian responded, “Return to work? That just can’t happen.”

Taxes, business debt, and other factors reduce the proceeds from a sale of a business, but unless you know the value of your business, how can you calculate your net proceeds?

If the projected net proceeds of the sale of your ownership are inadequate, we can help you bridge this resource gap through business growth planning.

Benefits of an Accurate Pre-Sale Valuation

Occasionally a valuation indicates that a company is worth more than what its owner assumed it to be. This is cause for joy because that owner may be able to exit her business sooner than expected and can transfer a portion of the excess value to family members or charity before the ownership transfer occurs.

If, however, a valuation indicates that the value of a company is less than its owner’s assumption, the owner also benefits by postponing the sale process until the business has sufficient value.

- **Accurate valuations increase odds of closing.** When owners assign sale prices to their companies that are greater than one determined by a professional valuation, the odds of closing the deal

plummet because the sale may not yield the net proceeds that the owner needs to achieve financial security.

- **Accurate valuations save money.** When owners assign an inflated sale price to their companies only to find that buyers are unwilling to pay that price, these would-be sellers spend tens of thousands of dollars and hundreds of hours on deals that do not close.
- **Accurate valuations point the way forward.** When a company is worth less than its owner assumes it to be, they learn exactly how much business value must increase for them to one day exit on their terms. Planning and action can then proceed to bridge the value gap.

Valuations In Ownership Transfers to Insiders

In this context, we use insiders as a blanket term for children or other family members, co-owners or partners, and employee(s).

In our exit planning practice, we use professional valuations when transferring ownership to insiders for two purposes: 1) To calculate the discounted value of minority interest in transfers to insiders and 2) To justify discounted value to the IRS in transfers of ownership interest to family members.

To achieve maximum tax efficiency and provide time to grow business value, transfers to insiders usually begin several years before owners intend to exit their businesses.

FOUR TYPES OF VALUATIONS USED IN EXIT PLANNING

There are several types of valuations, and the reason for the valuation determines which type we recommend. The most common valuations are:

1. A certified opinion of business value from a credentialed business appraiser
2. A calculation (or estimate) of value by a credentialed business appraiser
3. Software-generated valuation
4. An estimate of likely sale price by a transaction advisor (investment banker or business broker)

Let's look at each to help determine which method may be appropriate for your situation.

1. Certified Opinion of Value from a Credentialed Business Appraiser

An "opinion of value" from a credentialed business appraiser is the most expensive, extensive, and generally the most accurate form of valuation. As is true of most owners, Brian assumed that this type of valuation engagement was the only type available.

This type of valuation is appropriate when gifting or selling ownership to insiders for two reasons:

- Most gifting strategies involve the use of a minority discount, and an appraisal by a credentialed appraiser is generally required by the IRS.
- Sales of ownership to insiders usually involve an initial sale based on a minority discount designed to reduce the net taxes

on the ownership transfer. An independent business appraiser can calculate the discount as well as assign a value to the business that insider buyers find far more credible than the value owners provide.

2. Calculation (or Estimate) of Value by a Credentialed Business Appraiser

Many credentialed business appraisers will provide an estimate or calculation of value that falls short of an opinion of value because it does not include all the analysis involved in a certified opinion of value. In a calculation of value, business value may be presented within a range, rather than as specific value, and can be used effectively for planning a transfer of ownership to insiders.

3. Software-Generated Valuation

Software-generated valuations are normally preferable to relying on owner-generated valuations, but for Exit Planning purposes they are no substitute for valuation performed by business appraisers. This type of valuation can, however, provide owners with an independent assessment of business value. When our clients use valuation software, we ask their CPAs to review the valuation to confirm that it is "in the ballpark." If it is, we may use these valuations for initial planning purposes. We recommend that owners rely on more accurate valuations provided by credentialed business appraisers or investment bankers before transferring ownership.

4. An Estimate of Likely Sale Price by a Transaction Advisor

If you decide to sell your business to a third party, you need to know how much your business will likely sell for, rather than an

appraiser's determination of business value. Investment bankers can provide estimates of likely sale price based on current market activity and a limited review of a company's financial information. Note: These estimates are not business valuations.

COST OF VALUATIONS USED IN EXIT PLANNING

1. Certified Opinion of Value from a Credentialed Business Appraiser

For a "normal" business with \$10 million or so in revenue, this type of valuation typically costs \$7,500 to \$25,000. The wide range relates primarily to the complexity of the business and its location. For example, the cost of a business valuation in Fargo, North Dakota is likely substantially less expensive than that of an identical company in New York City.

2. Calculation (or Estimate) of Value by a Credentialed Business Appraiser

The cost of this type of valuation is generally about half to three-quarters of a certified opinion of value.

3. Software-Generated Valuation

These valuations are considerably less expensive and generally less accurate than those performed by credentialed business appraisers. We believe that software-generated valuations can be appropriate for the initial stages of Exit Planning.

4. An Estimate of Likely Sale Price by a Transaction Advisor

Investment bankers usually do not charge owners for estimates of likely sale prices if a business's EBITDA (or other measurement such as pre-tax income, or revenue) meets their minimum for representation—typically \$1 million to \$2 million of EBITDA.

TAKEAWAYS

- When owners fail to obtain an appropriate valuation at the appropriate time, they may base their decisions to transfer ownership on faulty information. Faulty information can prevent owners from leaving their businesses when they want, for the money they need, and in the hands of the party they choose.
- We encourage business owners to work with advisors who understand the benefits and shortcomings of all four types of valuation.
- The purpose of the valuation indicates which type of valuation is appropriate.
- Your professional advisors should:
 - Clearly explain to you the reasons for and benefits of a business valuation.
 - Recommend the valuation method that is most cost-effective and suitable for you and your business.
 - Be familiar with valuation experts who can perform reliable valuations.

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