HOW TO NAVIGATE

The Business Valuation Process Successfully

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INTRODUCTION

The prospect of getting a valuation for your business can be a daunting one, especially if the process is new to you and your organization. There's usually a lot on the line—and while you know what makes your business tick, you may have valid concerns about how well a third party can capture your story and present it to others for fair and reasonable consideration.

The purpose of this guide is to remove opacity from the valuation process. Valuation should not be a black box that involves mysterious weightings and factors, and outcomes that you are unable to trace back to performance and other fundamentals you understand so well. Rather, your valuation should provide welcome and objective illumination about your business as a whole.

Done right, your valuation is much more than just a report that serves the needs of a lender or other entity requesting it as part of their due diligence. It can be a critical tool to support your plans for growth or future business transition.

CHAPTER 1

First Things First: What Goes Into A Business Valuation, and Why Do You Need One?

A common understanding of the concept of business valuation includes terms like Fair Market Value, Enterprise, or Equity Value–which represents the value of a business as a whole, or for a percentage of a business.

To arrive at an estimation of value, as a starting point you can expect a valuation professional to:

- Review financial statements
- Identify income statement and balance sheet adjustments
- Review the business operation
- Determine the appropriate valuation model
- Review economic and industry data
- Compare market transactions of similar companies

The valuation will also likely consider additional factors:

- The capital structure of the business
- Prospects for future earnings
- The market value of physical assets

While the conclusion of value relies on the three standard approaches to value; Cost, Market, and Income, interpreting risk will vary from one valuation firm to the next.

Who Requests a Business Valuation–and Why is the Valuation Needed?

The need for a business valuation arises for several reasons, and the request can come from different sources. For a closely held business, the valuation plays an important role for a variety of purposes including but not limited to, business planning, determining tax liability, and listing a business for sale.

Lenders:
A prospective lender may request a valuation to suppport a loan being made for a business acquisition, partner buy-out, or the refinancing of debt. If you are pursuing SBA-backed financing, a specific set of valuation guidelines will apply to meet Standard Operating Procedures of the SBA.

Business Brokers:
If you are considering the sale of all or part of your business, a business broker (acting either for you or a prospective buyer) will need an objective and independent estimate of value for the business to anchor any negotiation.

CPAs or Financial Advisors:
Whether for the purposes of estate planning or eventual retirement, a CPA or financial advisor can use a business valuation to help you plan for a secure future for you and your family. Gift and estate tax returns that include a well-supported and documented valuation will help defend the value of the business to taxing authorities.

Attorneys:
Should you need to defend the value of your business as part of a shareholder dispute, purchase or sale process, or divorce, your attorney will need a credible valuation to support your case.

Different Types of Business Valuations

Complete Appraisal
The most detailed form of business valuation, a full-form or complete appraisal looks at every aspect of the business, and documents the methodology and assumptions used to arrive at the value conclusion. This is the level of valuation you need if you expect a challenge or a dispute that could end up in court. The American Society of Appraisers (ASA) and the Institute of Business Appraisers (IBA) issue standards that a comprehensive business appraisal should meet.

Summary Appraisal
A Summary Appraisal involves the same level of investigation and analysis as the Complete Appraisal, but delivers a summarized version of the salient information, which takes less time to prepare.

Calculation of Value
In some cases, a basic understanding of the value of a business will be sufficient for the task at hand. A Calculation of Value should not be considered in the same way as an appraisal – it arrives at an approximate value for the business, based on a limited amount of investigation and due diligence. At a lower cost and being prepared in a shorter time frame, it can be a useful tool to support management decisions when there's not a defined requirement for precision and documentation.

Appraisal Review
When you simply need a second opinion about a valuation report, an appraisal review offers commentary and critique that could lead to a better understanding of valuation prepared by another party.

Machinery & Equipment Appraisal
In many businesses, machinery and equipment represent a significant component of a business' value. A rigorous and accurate appraisal of key machinery & equipment, performed by an entity that knows the marketplace for such equipment, can be useful in the sale of assets, to collateralize debt, and to provide reliable data to help resolve disputes.

A Typical Process for Valuation

What are the typical phases of a business valuation, and what are the obligations you and your management team should expect to meet? While the overall process involves a predictable set of steps, the appraisal's objective will determine the depth and detail an appraiser pursues.

GATHERING INFORMATION AND PERFORMING DUE DILIGENCE

1. **Extensive Review of Financial Statements & Comparable Performance Metrics** A comprehensive business appraisal will naturally involve an extensive review of financial statements for your business to develop an understanding of core performance metrics. The valuation professional will also assemble and analyze industry and economic information, in addition to comparable business transactions in your industry–if available–to assess the relative performance of your business.
2. **Live Review & Discussion with Key Managers** The most reliable valuations involve boots on the ground to see the business in operation, and interviews with key members of the management team (when authorized)–numbers alone cannot and should not tell the whole story.

3. **Analysis & Report Preparation** Once these inputs have been gathered, verified and appropriately compared, it's time to analyze for value and prepare a report that is meaningful to both the business owner and the party who requested the valuation.

The same basic process applies to less-intensive valuations; the difference among various types shows up in the depth, detail and documentation of rationale a report provides, which depends, of course, on the purpose it needs to serve.

THE MOST DURABLE VALUATIONS ARE THE PRODUCT OF SCIENCE AND ART

You'll hear it said that business valuation calls for both science and art. Valuation science involves extracting a cogent, defensible story from the numbers, while the art deploys human wisdom and experience to ensure that less tangible–but always important – variables receive appropriate consideration.

CHAPTER 2

The Big Question: What Drives Value?

If there's a conversation underway about requesting a business valuation, the underlying question will always be around what exactly determines value.

Most business owners, lenders and other financial professionals understand that while there is a set of common, non-negotiable factors that goes into the valuation equation, other factors (and the weight assigned to them) will vary by industry, business structure and other individual characteristics of the business under review.

Common assumptions around value include emphasis on physical assets, track record for financial performance, trademarks, patents or even significant, long-term customer relationships. Of course each of these factors does contribute to total value, but often not as much some would expect.

CASH FLOW RULES

The indisputable king of valuation is cash flow. As every business owner knows, sales are just sales until they deliver a profit – ideally in a timely and repeatable fashion.

So, while a valuation professional will always study and consider the business' total financial picture as revealed by its financial statements, the appraiser is ultimately looking for a reliable pattern of positive cash flow to anchor the value of a business. When there's a solid picture in place for cash flow, every other aspect of the financial statements is more dependable, and the business is in a strong position to support maximum value.

FACTORING BUSINESS RISK INTO VALUATION

Cash flow is king, but then there's risk. Always, so the next question is how much risk? And what are the cash flow implications of that risk?

Risk presents itself in many forms, and the experienced valuation professional looks at each one to come up with an assessment of total risk facing the business, both long-term and short-term. Short-term risk might include a situation where the business is overly reliant on one or two customers for a substantial portion of its cash flow–what's the trajectory if one of those customers cuts back or goes away altogether? Other businesses face risk built in by seasonality and weather, and still others are subject to changes in trade policy or supply chain risk.

Longer-term risks are often tied to the general economic outlook, both local to the where the business operates and more broadly. Or they involve the industry's maturity, and that of any technology at the heart of the business–and emerging innovation that could change the playing field.

Often the most significant "value-add" provided by a business valuation is the comprehensive, clear-headed and objective assessment of risk, and its meaningful quantification. Experienced human intelligence plays an irreplaceable role in assessing individual business risk. Said another way, data is just data without human intelligence to evaluate and interpret actual risk.

VALUE BASED ON CAPITAL EQUIPMENT AND OTHER ASSETS

Yes, capital equipment can contribute to and is included in the company's total value. The equipment's age and condition are factors, as are its likely (or unlikely) liquidity in the event of a sale. Unless the equipment is specialized and in high demand, business owners can expect to see relatively low estimates for it as part of the total valuation.

Other assets commonly expected to contribute more value than they actually do include a business' unique differentiator or proprietary product. For the purposes of valuation, the more closely those assets tie into actual cash flow, the more they contribute to value.

CHAPTER 3

Valuation “X” Factors: Professional Expertise, Insight and Industry Experience Bring Crucial Context

As your business valuation gets underway, you need to be able to count on the valuation company’s commitment to:

- Accuracy
- Timeliness
- A holistic, defensible analysis that thoughtfully assesses and weighs both tangible and intangible elements that contribute to the value of your business, and supports the stated intent of the valuation

WHERE – AND WHEN – DO FORMULAS AND ALGORITHMS APPLY?

While every valuation company applies its own formulas and algorithms to expedite the capture and analysis of financial data, these formulas are just one of several essential tools in the appraiser’s tool kit.

Basic macros make the process of importing and organizing data from financial reports as efficient as possible. Seasoned valuation professionals have developed systems that enable them to look at a lot of data quickly, and isolate key variables for review – and most importantly, they know how the formulas have been built. This means they know what the patterns should look like, more or less, and when it’s time to break something down and study it more closely in case there’s underlying risk that needs to be addressed. One variable even just slightly off can compound quickly, and render a valuation unreliable.

Speed is important to the process, but not if it sacrifices accuracy. And while the right, current technology is essential, it should never serve as a stand-in for human intelligence.

COOKIE CUTTERS AND BLACK BOXES

If you need an immediate estimate of the range into which your business valuation might fall, an online valuation calculator can provide preliminary information. By engaging in the process of responding to standard, formulaic questions and plugging in numbers, you'll begin to get a sense for the metrics involved with typical valuation models.

The end product from an online valuation calculator won't provide much in the way of analysis. If the marketplace is active, however, you should gain a sense of how the greater marketplace assigns value. The exercise is similar to when the real estate agent pulls comps to help you price your house – you have a data point based on transactions for broadly similar entities.

Up another step on the ladder of expertise, you'll find valuation companies that provide a textbook business valuation, and promise your report quickly. Again, you'll do most of the work to complete a detailed questionnaire and input financial data. There will be a degree of human interface, but likely no site visits or in-person interviews about your business.

For either version of the entry-level valuation, you'll end up with a serviceable report that lays out the basic groundwork for valuation. What you won't get is an opportunity to genuinely understand the assumptions and methodology, or ask questions and challenge findings. And you won't find much discussion about intangibles. These models rely on a one-and-done approach, so they're executed quickly – but they may well suffice when you don't have a lot on the line.

WHEN YOU NEED THE MOST ROBUST AND DEFENSIBLE VALUATION

Above circumstances aside, the day will come when you need a thorough and reliable business valuation, one that genuinely reflects everything your business represents, and one that ensures you will receive all possible credit in any transaction or dispute.

In cases like this, accuracy matters more than ever. And while it's always ideal to get it right the first time, both you and your valuation firm deserve the time and discretion to revisit an initial finding that doesn't quite add up. Even a small discrepancy can have major implications for your final valuation.

EXPERIENCE. INDUSTRY EXPERTISE. PROFESSIONAL AND MANAGERIAL INSIGHT.

In many cases, a valuation will set the stage for the future of your business. Whether that future involves new financing, a sale or merger, additional equity participation– or new roads ahead as you plan an exit strategy, thoroughness and accuracy will pay more dividends than a speedy, plug-and-play deliverable.

For the most airtight valuation possible, it's important to build human intelligence into the process to interpret the big picture and spot any red flags or inconsistencies. And yes, technology can highlight an outlier, but it can't tell you why it cropped up – and technology can't discern between a simple error or oversight on the front end and a real discrepancy that deserves further study.

There's no substitute for hands-on experience in the valuation process. Experience matters to the quality of the valuation report, whether it's the product of a long and varied history completing different types of valuations for a broad range of entities– or brought from direct operating roles in industry, lending and finance. Regardless of its origins, experience supports facility with the numbers and an instinct to know when the story told by the numbers is missing a layer that could make a material difference.

And while conventional financial analysis plays an important role in the process, true valuation expertise plumbs deeper because the intent and endpoint serve a different need. This is where training and professional valuation credentials are important, such as those earned from the following organizations:

- American Society of Appraisers (ASA)
- National Association of Certified Valuation Analysts (CVA and CBA)
- American Institute of Certified Public Accountants (ABV)
- Institute of Business Appraisers (IBA)
- International Society of Business Appraisers (BCA)

A valuation professional trained and certified by these organizations will ensure the valuation meets all established standards, and holds up to the daylight brought in with deeper scrutiny or even a challenge from another party.

CHAPTER 4

Arriving At A Valuation That All Parties Can Stand Behind

No matter who's requesting the valuation for your business – and for what reason –you will have greater confidence in the end product if you have an opportunity to engage with the process.

The most reliable valuation is one that involves collaboration and live exchange among all key players: the valuation professional, the business owner, and key members of the management team should work together to ensure all the facts are properly understood.

With an open forum, there's no rush to judgement – and there should be appropriate opportunities to revise or reconsider certain components. Additionally, you'll gain a better understanding of your business from the valuation perspective, which might be quite different from a viewpoint based on daily operations.

Look for:

- A demonstrated commitment to comprehensive information-gathering and all appropriate due diligence
- Time, experienced talent and resources allocated to assemble and analyze data – to enable a full understanding of all of the drivers that contribute to business performance
- A credible rationale to assign weight to subjective factors
- A logical breakdown of various risk factors that identifies both internal and external contributors

The valuation that will serve you best is one that documents and follows a process you can trust, and stands on its own merits to tell the whole story of your business.