

Why understanding valuation can help

By Rosanne J. Aumiller

If you want your business to have a long and prosperous life, you have to plan for its succession before you are ready to turn it over to the next owner. Understanding how value is measured can help you, as a business owner, to position your company in order to maximize its value to a prospective buyer.

Most people understand that the stock of a public company is traded on an exchange and the price can be easily looked up at any moment. Privately owned company stock value can be determined as of a specific date by utilizing valuation methods. These include cost, income and market approaches. Valuation is about measuring *risk* and *reward*.

As it relates to the equity value for a privately owned company, *risk* is captured in the rate of return an owner expects to be compensated for the investment. The *risk* measurement, or rate of return, is known as the cost of capital.

A business owner who invests, say \$100,000 in a privately owned business would expect a higher rate of return than one could obtain from alternative investments because of the risk inherent with generating profits for the company. Additionally, there is greater risk with a long holding period before realizing any appreciation in the stock and with no active market to sell the stock.

Reward is captured in earnings. Earnings can be defined as net income, gross cash flow, EBIT, EBITDA, etc. However, earnings are better defined as net cash flow. That is the net cash flow available to a company after paying its bills and providing for reinvestment to grow the business. Net cash flow may be used to repay debt principal and interest and give the owners a return on their investment.

Look at the following components of *risk* and *reward* as they relate to your business. Make adjustments when you can in order to help positively impact the *risk* and *reward* when measuring the value of your company. If you find your company facing any of these factors,



what can you do to change things, knowing how it may affect the value of your business?

Many businesses found that the following risks were magnified and may have been the primary factor that reduced the value of the business by increasing the *risk* and reducing the *reward*.

- Heavy reliance on bank credit
- Significant customer or supplier concentration
- Operated in the auto or other high risk industry
- Had high fixed costs or other specific risks

Other factors that impact the *risk* and *reward* measurement may include:

- Access to capital — can the business obtain bank financing and/or private funding? Many smaller private companies need the owners to sign personal guarantees for bank debt.
- Private companies generally have a goal to minimize taxes, which is achieved by recording higher expenses to get lower net income. There may be discretionary

expenses that can be added back to increase earnings to show the true economic benefit of a business.

- Diversification: geographic area served, number and type of product lines, vertical integration, single or multiple locations, etc.
- Reliance on key manager(s) vs. broad and seasoned management team
- Growth prospects — look at historical growth rates and the causes. What does the future hold? How can the business grow both the top and bottom lines?

Given the uncertainty in market conditions and our current economic crisis environment, business values are generally lower at this point in time across the board. Just as the double-digit interest rates of the 1980s came down and the dot-com bubble of the late 1990s eventually burst, this too shall pass. How long before we return to sustainability is an unknown that negatively impacts value.

But understanding what others will be looking at when determining the value of a privately owned business can help you today to move in the right direction when planning for the future of your business.



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