



FIVE REASONS YOU NEED TO KNOW WHAT YOUR BUSINESS IS WORTH WHITE PAPER

Few business owners relish spending money on something they don't need. And for most owners, hiring an expert to estimate the value of their companies falls into that don't-need category.

So 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—better than any so-called expert—know what it is worth!"

Before you join these owners and scratch "Business Valuation" from your list, consider just five reasons you should put "Estimate of Value" at the top of your list. An estimate of value:

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.

If you still are not sure that your list requires rearranging, rest assured that an estimate of value:

- Is not the full-blown opinion of value that you will need just prior to your transfer of ownership;
- Costs about half as much as a standard opinion of value (because it lacks the supporting information contained in a standard opinion of value);
- Is the basis for the (later and) complete valuation; and
- Is used for planning purposes only. It cannot be relied upon for tax or other purposes.

Reason 1: Establish your starting line and distance to the finish.

To create Exit Plans for owners we use a seven-step process that is based on each owner's unique objectives. The three primary objectives owners set are: 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; and 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 or rules of thumb, informal or casual estimates because these yardsticks rarely take into account variations in revenue, cash flow, location, reputation, proprietary technology, contingent liabilities and other factors that can have a significant effect on the value of a particular business.

So, how else do you determine your starting point—today’s value—without the estimate of an experienced, trained business valuation specialist?

Or, if you subscribe to the “It’s not where you start, it’s where you finish” school of thought, can you admit that it might be good 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 starting point nor 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? Of course not—nor should you sell or transfer your business to anyone without *first* determining its worth.

Reason Two: 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 me (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 \$7,000,000 (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 if 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 time line or lower your financial expectations.

Reason Three: Basis for Tax Planning

As you consider various exit paths (sale to third party or 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. Given that tax mitigation strategies often take years to implement, it is critical that you start planning

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.

well before you exit and that you use an accurate estimate of value.

For example, in a transfer to key employees, a common transfer technique (designed to reduce both 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.

Reason Four: Litmus Test

Owner Effort / Target Buyer / Buy/Sell

Suppose an owner is ready to leave the business—if that exit yields financial security. That owner must calculate the amount of cash needed to assure financial security and subtract from that the value of the business today. The resulting "gap amount" tells the owner how much value she needs to create to meet her objectives as well as where she needs to concentrate her time and effort. Instead of growing value for the heck of it, dedication to a goal enables many owners to exit sooner with the same amount of after-tax cash than owners who do little or no planning. Exit plan success all begins with a starting value.

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 as well as on the conditions under which a transfer is

made. For example, an appropriate business value for a third-party sale may be significantly higher than that established for a transfer of the same business to key employees over time, or 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 not only on the intrinsic value of the business, but on the "external" condition of today's 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 (how much of the deal price is to be paid in cash or seller carry-back note, or in earn-outs) of a possible third-party deal.

Buy/Sell

Value is not only relative based on successor choice, it fluctuates depending on how the owner plans to use the valuation. In co-owned companies, unless owners periodically update value established for the 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 goes to court.

Reason Five: 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.

To do that, 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 value should be determined. Even though you may (for tax and other reasons) decide to sell the business at a

low value, employees may not consider the value to be low. Anticipate these concerns and use an independent valuation to allay them.

Cost

The cost of an estimate of value can vary from \$0 to \$25,000 depending on who performs the valuation: you using free on-line valuation

software, transaction intermediaries, non-certified advisors, or Certified Business Appraisers.

The cost for an estimate of value can also reflect the complexity of a business and the region of the country where your company does business.

For a “normal” business with \$10 million or so in revenue, a valuation typically costs \$5,000 to \$15,000 and an estimate of value costs 60 to 75 percent of that amount. When

the value calculation is upgraded (usually just prior to the sale) the valuator will charge an additional 25 percent.

With all the “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 are CVA (Certified Valuation Analyst), ASA

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.

(American Society of Appraisers), ABV (Accredited in Business Valuation) and CBA (Certified Business Appraiser).

Failure to Value

If the cost of a valuation seems too high or just plain unnecessary, compare it to the cost of:

- 1) Leaving money on the closing table because you underestimated the company's value, or
- 2) Appearing before the IRS to defend a rule of thumb value—unprotected by a proper valuation.

An estimate of value at the outset of planning helps you to target your value building efforts and to move efficiently toward a goal.

CONCLUSION

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

ⁱ “It’s Not Where You Start” by Dorothy Fields and Cy Coleman, ©CHRYSALIS MUSIC OBO NOTABLE MUSIC , CHRYSALIS MUSIC ALDI MUSIC CO