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How to Determine a Realistic Value for Your Client's (or Your Own) Business

What a business is worth to the owner is often very different from what it's worth to a potential buyer.

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Knowledge of a company's true value is essential for business owners and their advisors to assure that the client will receive reasonable value in a transaction, to prepare clients on what to do if they're approached by a prospective buyer or even to help them develop a plan if they are considering selling their business in the near future.

In all these situations, owners must know their business's true value to determine their next move. How will the sale be structured? Is the proposed price a reasonable price or just a shot to see if the owner might grab it? Although valuation is so critical to know, most business owners are at a loss when it comes to determining it. The danger is that such owners may begin pursuing a transaction with a third party without consulting their advisors, and that could be problematic, especially if the owner has inappropriate assumptions of the business's value.

Unfortunately, some owners will underestimate their business and its value, which could cause them to leave a lot of money on the table and, ultimately, come up short in a future transaction. Conversely, some owners overestimate the value of their business causing them to be left empty-handed as they turn down a reasonable price for their business because they mistakenly think it's worth much more. The latter situation can be especially problematic for an owner with no family heirs to the business or who has a health challenge or other issue that makes a sale important to consummate soon.

Determine an Appropriate Value

It's critical for the owner and advisors to have a realistic and objective value of what the business is worth prior to beginning a transaction. A common, and often very costly, mistake is to just use the business's reported earnings as the sole basis for the valuation. Reported earnings often don't paint a complete and accurate picture and can give an erroneous image of the company's true worth. Therefore, other factors need to be considered as well, such as normalized or adjusted earnings, which will factor into things like excessive salaries and expenses that are really owners' perks. Earnings that are "normalized" may also be adjusted for unusual nonrecurring events—for example, a problem of a supplier that slowed sales for a given year but is very unlikely to recur or a new development that makes current earnings more reflective of future earnings than historic earnings that occurred prior to the development.

The best way to determine value is to start by looking at earnings, but then to dig deeper and examine the quality of those earnings so that the unique aspects of the client's business can be incorporated into the analysis. That more robust approach could add or detract significant value. For example, if your client sells product into a certain geographic or demographic niche that prospective buyers are eager to penetrate, then buyers might be willing to pay more for your client's company because of the value that this niche brings to that specific buyer. Thus, the acquisition of your client's business by a strategic buyer could add significantly to what the client ultimately realizes.

On the other hand, there are factors that could lower the valuation of your client's business. Questions an advisor should ask might include: Are there customer or supplier concentrations? Would the loss of a key customer or vital vendor lead to a significantly negative impact on revenue?

Perspective on the Value

A key aspect of valuation is not to focus on what the business is worth to the owner but what it's worth to a potential buyer. Buyers are often planning to take your client's business "to the next level." So, the client should therefore address and weigh the current value of the business as well as the potential value to the prospective buyer. That value includes intellectual property, a market niche, special client base or other strategic aspects that could be lucrative to a buyer.

Example: The company to be sold is a manufacturer of cleaning products; its customers are the Department of Education in most of the 50 states. They're bought by a European manufacturer, who highly values the relationships, perhaps even more than the products, and wants an entrée into the many Departments of Education. They were willing to pay a significantly higher multiple to gain access to this market niche to enhance their overall business. Had the client simply sold the business based on a typical hypothetical buyer's price, the excess niche value realized here would have been lost.

Broadened View Locates "Hidden" Value

To determine the true value of a business, many factors need to be considered. While some less-qualified appraisers will determine the value based on "the numbers," an appraiser or investment banker may combine solid financials with a broadened view that can provide different vantage points on the soft details of your client's business and find the "hidden" value in their company. Select a firm that has experience with M&A and valuations and a group who is familiar with selling companies similar to your client's business. Estate planners should address these issues with clients as part of an overall estate plan.

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