March 18, 2019

How a Business Valuation Can Make Your Sale More Profitable

A business owner preparing to sell a company could make a costly error in foregoing a detailed, independent valuation to determine the company's worth — or in waiting until the last minute to obtain one.

For example, a business owner with a piece of land containing timber, with no view in a rural area unlikely to be developed for years, may draw an appraisal of $20,000 if the assessment looks at the property simply as a place to live.

A valuation that includes a timber "cruise" — an assessment of the property's commercial potential — might push the land value to $1 million, said Natasha Davis, senior wealth planner at City National Bank.

Earlier in her career, Davis set up an estate plan for a client who brought in an appraisal valuing his business at $4 million. "I said, 'There's no way you have $4 million in assets because you're bringing in $10 million a year,'" she recalled.

Ultimately, a more thorough and accurate appraisal was done, resulting in a $40 million valuation for the business.

Simply put, a business owner could miss significant value in his or her company without a detailed third-party valuation, yet many people skip, overlook or skimp on this important step.

Why It's Vital To Obtain the Right Valuation Before Selling Your Business

Formal valuations delve into various facets of a business to recognize its true total worth and to identify the steps that owners could take to enhance the company's value to potential buyers, exploring factors not covered by a broker's simple appraisal.

In the case of family businesses, they also enable owners to properly value discounted shares being sold to children or other relatives.

"The value is in the eye of the beholder and there is a range on the value from the perspective of the buyers," said Michael Haghighat, founder and managing director of valuation firm Globalview Advisors LLC, a global firm that specializes in financial valuations. "It's helpful for the seller to know the range of value they might expect if they expose their company to the marketplace."

Notably, independent valuations also are vital in defending against any IRS challenge to the sale price after a transaction — a particular risk when transferring a business to family members. An IRS challenge can result in hefty penalties and tax bills, as well as attorneys' fees and court costs, if the government finds the sum strayed too far from market value.

A valuation is "extremely detailed," said Davis. "It's going to give you a true value of what the business is worth, and it's also going to give you a true value of the discounts that apply when you're passing it internally."

In addition to financials and balance sheets, a valuation may consider a company's locations, marketing, competition, unique property, recessionary resilience, clients and other intangible goodwill assets, such as a long track record and great reputation in the industry.

THE SELLER VS. BUYER MINDSET

In thinking about valuations, it's important to understand the difference in buyer and seller mindsets, said Haghighat, who has more than 30 years of valuation and transaction advisory experience.

Sellers typically think historically. They have built a business over many years and now aim to exit and monetize the value they have achieved in starting the company, acquiring customers, and creating processes or technology, he said.

The buyer's perspective is more forward looking. They're interested in seeing what the business will be able to do and how to take it into the future; a potential buyer might view what the seller has built more as an indicator of what's possible next, Haghighat said.

Among other details, buyers want to know whether business processes are documented or whether they're contained only in the seller's head. The valuation will be lower if business processes exist only between the seller's ears, he noted. Potential buyers also care about the current and potential customer base, and the extent to which the business depends on the seller's personal efforts.

THE 3 APPROACHES FOR VALUING A BUSINESS

Valuation methods vary depending on industry, the business's development stage and the purpose for the valuation, which in addition to a company sale also may include litigation or financing. Approaches also may differ by type of deal, with a sale to an outside buyer or a partner likely requiring a different kind of valuation than a sale to family members.

All valuation types fit into one of three general categories, Haghighat explained: the income approach, market approach and adjusted balance sheet approach.

Income Approach

The income approach utilizes a discounted cash flow analysis, which determines a company's present value based on its estimated future cash flows, taking into account historical performance and future growth opportunities and risk factors.

Market Approach

A market approach examines acquisitions of companies in the same sector with similar characteristics, assessing their deal multiples, which are price-to-earnings or price to EBITDA (earnings before interest, taxes, depreciation and amortization).

It also may involve coming up with multiples approximating those achieved by publicly traded companies in a similar industry, Haghighat noted.

Adjust Balance Sheet Approach

The third type of valuation, the cost or adjusted-balance-sheet approach, involves restating assets and liabilities on the balance sheet based on their fair market value. This method applies mostly to holding companies, or to early-stage ventures where assets tend to be valued by their replacement costs, he said.

An income or market approach — or both — makes sense for most businesses, according to Haghighat, who said Globalview usually uses at least two approaches in calculating a company's valuation.

"It's a single valuation, but that single valuation would employ both of those approaches," he said.

By applying as many methods as are feasible, a company should arrive at a more reliable indicator of value, Haghighat explained. The valuation could be a range or a single value point, although sellers typically use a range.

PROACTIVELY PREVENT CONFLICTS WITH THE IRS

Owners transferring a business by gifting portions of it to their grown children over several years would need to update the valuation annually to account for new financials and any major changes, said Davis, explaining that the price can rise or fall over time because the parents maintain ownership while they're gifting.

"If you don't have a valuation and the IRS challenges the price, they'll do their own valuation and you're stuck with what their valuation is, as opposed to proactively doing a valuation in order to do a gifting strategy," said Davis.

If selling to a third party or a partner, on the other hand, an owner would need only a one-time valuation for the buy-sell agreement and promissory note, even if the sale will occur over a few years, she said.

Of course, there's no guarantee that offers from potential buyers will match the valuation, but a thorough report can help inform an owner's decision-making, including consideration of possible alternatives to a sale.

It's important for business owners to understand a valuation's importance and why they're having one done, said Davis. She considers the process necessary for effectively transferring interest in a company, and said a valuation, which can range from $5,000 to $30,000 for most small businesses, shouldn't be cost-prohibitive.

If the IRS were to come back and challenge the sale price and ultimately require the owner to pay extra taxes plus penalties, said Davis, that's going to be much greater than the cost of the valuation.

Obtain a Business Valuation Sooner Rather Than Later

It's best for sellers to obtain a valuation three to five years before their desired exit from the company, giving themselves time to enhance the business's value to buyers, addressing issues such as business continuity, customer stickiness and scalability, Haghighat explained, adding, "They shouldn't wait until they are ready to exit to see what the business is worth."

Given the complexity and the number of options available, it's important to consult with professionals to evaluate your situation before a sale. City National Bank's wealth planners can help you weigh your options.