Insights on VALUATION

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Baby Boomer Business Owners: Start Exit-Planning Now

Baby boomer business owners in the United States are looking to turn their years of sweat and toil into cash for retirement, but the faltering economy rapidly turned the seller's market of a few years ago into a buyer's market, negatively impacting value.

Adding to their woes, the large number of baby boomers who own businesses wanting to sell will likely result in a glut of businesses on the market in the coming years, which can further depress prices. And finally, most business owners wait too late to begin exit-planning,

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and delays can be costly in time and money. But with a well-planned strategy implemented sooner rather than later, some business owners can still realize their dream of life on a tropical beach.

According to a recent survey conducted by Orion Capital Group, LLC, 47 percent of middle market business owners are considering selling their businesses within three years, and, surprisingly, over 90 percent of those business owners have not initiated a planning process. By waiting for the last minute to make a decision to sell, these owners may be missing significant opportunities and not realizing the optimal value of the businesses they worked so hard to build.

What can the baby boomer business owner do? First and foremost, start early. Experts suggest that small firms get organized three to five years (some even say seven years) before they even start to think about transitioning out of their business. This long lead time is necessary for two primary reasons; first, prospective buyers have become more sophisticated and are looking for a long history of the business that includes good financial records and operating documentation; and second, it may take some time for the business owner to implement changes that can enhance the value of his or her business.

Business professionals such as valuation analysts, certified public accountants (including tax specialists), financial planners, and attorneys can orchestrate a comprehensive exit plan that will benefit the business owner in a number of ways, including minimizing taxes and legal fees related to the sale or transfer of a business to maximizing the price received for a business. For example, many buyers prefer that the owner remain with the business for a number of years after the sale in order to smooth the transition. If the owner waits until they want to walk away from the business without a transition period before they sell, this usually results in a lower sales price as the buyer perceives a greater risk without a transition period. Adequate planning that includes a transition period can eliminate the buyer's risk and result in a greater price for the seller.

Well documented financial information is an important consideration in the planning process. Many small and middle-market businesses look upon formally prepared financial statements as an unnecessary expense, but buyers gain a greater sense of comfort in looking at a financial statement that has been audited or reviewed by a reputable accounting firm than one that has simply been printed off the business' computer. And what goes in those financial statements is extremely important. If the owner is running a large amount of personal expenses through the business, this has a negative impact on operating profitability and cash flow, two key factors examined by a potential buyer.

Another consideration for the business owner is what my business is worth and what can I do to maximize that value before I sell? Many business owners have unrealistic expectations of the value of their business and this can make it difficult for the sale of the business. A valuation analyst can advise the business owner what his or her business is worth and, through their analysis, suggest ways in which that value can be increased.

Although this article addresses the issue of business owners and retirement, it should be noted that an exit-planning strategy should be developed by all business owners, whether facing retirement or not, in order to prepare for unexpected events, such as disability or even death. Exit-planning should be a normal part of the business planning process.

Understanding Business Valuation Reports

Whether you are a practicing attorney, an investor, or a small business owner there may come a time when you need to read and understand a report written to support a conclusion of value for a business. A well written valuation report is difficult to understand by those who are not well-versed in the terminology and principles of business valuation. Often, a well written report can mask serious deficiencies in assumptions and foundations for the valuation that render the conclusions irrelevant and/or wrong.

There are several very common errors that are easily identified by a valuation professional but might be completely missed by someone who is not accustomed to evaluating valuation reports. The following is a checklist to assist you in evaluating a report to at least catch basic problems and errors. Some of the most common errors follow:

- Math Errors: Even the most sophisticated looking reports can contain mathematical or calculation errors. In a business appraisal, one error early in the process can have a dramatic impact on the conclusion of value. Even if you do not want to sit down with a calculator to verify the calculations perhaps you can delegate the task. Somehow, it should be done.
- Mixing Tax Attributes: An example of the most common error with, often, the greatest impact on the conclusion of value is the application of pre-tax capitalization and discount rates to after-tax cash flows and earnings, and vice versa. Although this seems like an obvious problem and easy to see, it can be difficult to catch. If, upon

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reading the report, you cannot tell whether the capitalization/discount rate is pre-tax or after-tax you should call the author of the report and ask him/her to show you where it is stated in the report. This can be the beginning of a process that may result in the discovery that there is a mismatch.

- Incorrect Standard of Value: Without getting too technical, this error is akin to getting a piece of chocolate cake delivered by the waitress when you asked for a slice of chocolate pie. The impact, though, can be much more significant. For example, you are involved in a stockholder dispute and, as a part of the litigation process, a valuation report is ordered. If the appraiser reports the value on a Fair Market Value standard of value the report is irrelevant in most cases. Since the Fair Value standard of value is likely the appropriate standard of value in a dissenting stockholder action the appraiser has produced a report that may come to a correct conclusion (Fair Market Value) but cannot be used by the court because it presents an incorrect conclusion (Fair Value).

- Misapplication of "Market Data," many business appraisers like to use publicly traded companies as "market comps" much as a real estate agent uses similar homes in a neighborhood to provide "market comps." This is not the error. The error is using public company transaction data without adjusting for the additional risk associated with small companies (size risk) and the unique risks associated with the subject company (company specific risk). This error almost always results in an overstatement in the value of a company.
- Miscalculating Discounts: When valuing an interest in a business (less than 100%) the appraiser is likely to apply discounts for lack of control and lack of marketability. If both discounts are 20%, the cumulative impact may be reported as 40%. This would be incorrect and result in an understatement of value. This is so common that even courts make this mistake on occasion! (e.g. *Kosman v. Commissioner*, T.C. Memo. 1996-112) The proper affect of the two discounts is not additive (20% + 20% = 40%). They should be applied sequentially (1-([1-20%] x [1-20%]) = 36%).

All of this may seem complicated and it is. That is why common errors can easily be missed by users of valuation reports. It may be well worth your money to have a professional valuation analyst review the report for you and provide a detailed analysis of not only errors but also weaknesses in the assumptions, methodologies, and conclusions. A Certified Valuation Analyst is trained in valuation and reporting and is qualified to do this type of work.

Rules of Thumb—Are They Useful?

Rule of Thumb: An Italian restaurant should sell for 30% of gross revenue. Valuation completed! Draw up the paperwork, right? Reducing the complexity of business valuation to rules of thumb is an appealing proposition. Avoiding complex cash flow calculations and side stepping necessary adjustments makes the process of valuation more appealing and more accessible to the lay user. However, one must still deal with the dilemma: "Should it be done simply because it can be done?" Is there value in the simplicity of rules of thumb?

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The answer is "maybe." It all begins with the intended purpose of the valuation. An early retiree seeking a second career might use the methodology to narrow down the number of potential investment selections. The business owner in the initial stage of succession planning may need a number to allow him to work through the steps in the process. The aging parents concerned with equitable distribution when leaving a family business to their children. There are many other examples where a "quick-fix" calculation is a necessary first step to addressing a specific situation. Later, as the process progresses, additional detailed analysis and more sophisticated methodologies can be used to replace the rule of thumb value. The value determined by the rule is simply a bookmark to be replaced at the appropriate time.

Rules of thumb based on actual completed transactions are perhaps the most useful. These types of rules theoretically approximate the Market Comparison Approach. The word "approximate" should be used loosely, as there will no doubt be differences between the subject company and the rule of thumb "average." Theses differences include but are not limited to: expense structure, age of equipment, building lease term, cash flow trends, and specific competition. Equally important are the terms of sale. A rule of thumb based on seller financing likely produces a different result from a rule based upon a cash purchase premise.

How does the rule address inventory, real estate, and debt? Unless the rule specifically states how these issues are addressed, one cannot know if they are accounted for in the rule. Is inventory and real estate added to value? Is debt subtracted from value? The answer to either question can impact value dramatically.

Yes, rules of thumb are quick and simple. If properly understood and applied correctly, they can be useful in some valuation situations. Unfortunately, the only thing certain about their use is the uncertainty as to the comparability to the target situation. A single formula cannot address all of the company-specific differences. Furthermore, users should be aware that rules of thumb from different sources are not necessarily comparable. The source of the rule is important. Independent, professional sources utilizing data based on completed transactions would more likely provide market-driven rules.

Rules of thumb are useful. The source of the rule must be identified and the underlying assumptions understood. Professional business valuators can assist in determining the appropriate application of a specific rule in a given situation.

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