Build Your Business

An eNewsletter for
CEOs looking to
grow their companies.

High-value, “how-to” articles on customer-attraction, sales development, leadership, and best-practices in HR, IT, product development, communication, financial operations, engineering and M&A/value creation.

Finding the Street Value of a Privately Held Company

If you looking to determine the real (street) value of your company, this article defines straightforward approaches to help you.

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Finding the Street Value of a Privately Held Company

If you don't understand the Value of your company how can you improve it!

Are you looking to determine the real (street) value of your company? Are there too many opinions and methods for you / your team to work through? Do you need to straightforward way you can repeatably determine your street value?

This article will help you get there.

"What is the Value of My Business?" It Depends.

When dealing with the owners of a closely held business, one of the first questions we are asked is to determine the value of their business. The valuation of a company is different depending on who is doing the valuation. Banks value business differently than buyers, and buyers can be broken down into two main groups: financial buyers and strategic buyers. Each has a different view of value.

Financial or economic buyers are willing to base value on assets, earnings, growth potential and return on investment. While financial buyers are looking for companies with growth potential, they usually base the price they are willing to pay on current and past performance, not future or projected profits.

Strategic buyers may or may not place much weight on the economics of the business and instead may have strategic reasons for acquiring the company. The reasons could include such benefits as distribution rights; the ability to eliminate a major competitor; gaining market entry without startup cost; patented products, and the reduction of manufacturing or production costs. For these reasons, a strategic buyer may pay a higher price than a financial buyer would. Strategic buyers represent less than 10% of the total buyers. As such, we do not recommend setting value based on this group of buyers.

Four Steps to Determining Your Company's Value

Understanding the value of your company and how the value was determined allows you to work on key drivers to improve the value.

Discussed below is a straightforward four-step method that allows you to establish a base value. The calculation of the base value is designed to create a method of business valuation that is easy to understand and is based on Piper Group Internationals three decades of middle market experience of what businesses actually have sold for. We call this method "Finding the Street Value".

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The four steps are:

Step One:	Determine the Asset Value
Step Two:	Determine Profitability before Tax Strategy
Step Three:	Determine the Enterprise Value
Step Four:	Determine Owner Equity or the Value of the Stock.

The first step is to determine the Asset Value of your company. The value of a business can be broken into two basic components. Tangible and intangible. When determining the asset value of a business you are dealing with the tangible components of value. These include such items as cash, accounts receivable, inventory, equipment, real property and long term assets. All of these assets make up the balance sheet of a company.
To determine the asset value of a company you first need to take out the tax strategy associated with your balance sheet. To do this you will need to recast your balance sheet from GAAP (book value) to a FMV (fair market value) asset list on a debt free basis. Personal or non-operating assets are generally retained by the seller and deleted from the list (think motor homes and second or vacation homes).

Current Assets should be adjusted as follows:

- Deleted – Excess Cash and Marketable Securities. Cash reserves for working capital may be included depending on the business requirements.
- Inventory – Should be purged of all obsolete inventory.
- Accounts Receivable – Discounted for aged receivables.

Fixed Assets:

- Recast all Equipment to FMV. Adjust the value to what a dealer would sell the equipment for in their current condition.
- Real estate owned. Delete any company owned real estate because it is valued differently than a business. Market rent is imputed on the income statement as an expense.
- Leasehold improvements can be included if they are in good condition and still in use as some deprecated value. Buyers may not accept a value for these assets since it is improbable they could be included in a sale or liquidation.

Current & Long Term Liabilities are removed from the balance sheet to show a debt-free asset value.

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Recast Balance Sheet to Asset List

	Actual	Asset List
Current Assets		
Cash	$50,000	0
Accounts Receivable	$350,000	$350,000
Securities	$80,000	0
Inventory	$100,000	$100,000
Current Assets	$580,000	$450,000
Fixed Assets		
Equipment	$2,000,000	$1,300,000
Real Estate	$200,000	$0
Motor home	$150,000	$0
Less Accum. Depr.	($1,950,000)	$0
Book Value	$400,000	
Dealer Fair Market Value		$1,300,000
Total Assets	$980,000	$1,750,000
Trade Payable	$300,000	$0
Funded Debt	$600,000	$0
Total Liabilities	$900,000	$0

As you can see in the example the Asset List Value for this company when adjusted to fair market value and the tax strategy is taken out is $1,750,000 as compared to the $980,000 on the actual balance sheet. Remember the objective is to show what assets are to be included in a proposed sale with the fixed assets valued at FMV.

Note: Every transaction is different as far as what is sold as far as assets; this is to show you what is typical and how to establish value.

Step two in the process is to determine your profitability before tax strategy. I have owned several companies over the last 30 years and if you're like me, I was always (and still am) trying to make as much money as possible and pay as few taxes as permissible. The only problem with doing that is when it comes time to sell your company your financial statements will not show your companies true earning potential. To do that we take a GAAP Income Statement and recast it to EBITDA or Earnings before Interest Taxes Depreciation and Amortization. By doing this we are taking the tax strategy out of the GAAP Income Statement and showing the ongoing expenses and corresponding profitability a new owner should expect to receive based on historic and current financial statements.

When determining which time period to use the rule of thumb is as follows;

> *If year to year sales have been level or increasing and if the current year to date sales are equal to or greater than the same period in the previous year, most buyers will then use the last fiscal year end as a basis for etermining profitability.*

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When recasting an income statement generally the following items are adjusted or deleted:

- Owner compensation is replaced with a market level salary and perquisites, bonuses are deleted
- Non-recurring expenses are deleted
- Non-essential expenses are deleted
- Interest is deleted
- Rent included or adjusted to market
- Depreciation deleted with EBITDA. If the company is capital intensive, a capital expense will probably be included by a buyer.
- Income taxes are deleted.

The sample statement on the next page shows how a company reporting a net profit of $1,989,500 when recast shows an EBITDA of $2,565,500.

	Actual	Notes	Recast
Sales	$6,250,000		$6,250,000
Less Cost of Goods	$2,500,000		$2,500,000
Gross Profit	$3,750,000		$3,750,000
Expenses			
Payroll	$1,000,000	1	$900,000
Payroll Taxes	$150,000	2	$135,000
Office Expenses	$30,000		$30,000
Interest	$125,000	3	$0
Professional Fees	$90,000	4	$25,000
Telephone	$3,000		$3,000
Rent	$65,000	5	$75,000
Depreciation	$300,000	6	$0
Repairs & Maintenance	$10,000		$10,000
Insurance	$8,000	7	$6,500
Total Expense	$1,781,000		$1,184,500
Operating Income	$1,969,000		$2,565,500
Other Income			
Sale of Assets	$15,000		$0
Interest & Dividends	$5,500		$0
Total Other Income	$20,500		$0
Net Profit	$1,989,500		
EBITDA			$2,565,500

Notes: [1] Any and all adjustments will be examined rigorously by a potential buyer. If the adjustments are not defendable your value will be questioned. [2] Having accurate, clean and detailed financial information will lend creditability to your recast numbers.

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Step three is to Determine Your Enterprise Value using The Economic Feasibility Method.

Using the earnings of your company or EBITDA we can find a value by applying the Economic Feasibility Method. Simply stated the EBITDA or earnings of a company must accomplish two things to establish a valuation. The first is it must provide a buyer a reasonable risk rate of return and the second is that it must service the debt payments of the acquisition financing.

We have found that most financial buyers are willing to accept a 20% pretax Rate of Return (ROI) on their invested capital for an established and predictable business. The starting point where Price or Value and Economic Feasibility begin to accomplish both the ROI and support the acquisition financing is around a multiple of 5 times EBITDA or earnings. Using this as an example, let's do the math.

Application of the Economic Feasibility Method;

Estimated Sales Price	$5,000,000
Invested Capital (Down Payment)	$2,000,000
Balance Due	$3,000,000
Invested Capital	$2,000,000
Risk Rate of Return	x 20%
Return on Investment (ROI)	$400,000
EBITDA	$1,000,000
ROI on Down Payment	$400,000
EBITDA available for debt service	$600,000

The EBITDA available for debt service after the ROI on the invested capital is $600,000 per year or $50,000 per month, which will pay off the acquisition financing of $3,000,000 at 6% per annum in approximately 6 years. Given the down payment, ROI and terms available for financing, this is an economically feasible transaction.

Let's take a look at how the value of a company's assets and goodwill can come into play when establishing Enterprise Value. We call this the risk rule. For buyers, the risk relates to what happens if the acquired business is not successful. If the business fails and there are assets to liquidate, some of the original investment can be saved. Looking at two different companies with the same EBITDA but different asset values will help to demonstrate the point.

Asset Based Co.	
$1,000,000 EBITDA x 5 =	$5,000,000
Less $2,500,000 FMV Assets =	($2,500,000)
Goodwill (50%)	$2,500,000
Low Asset Based Co	
$1,000,000 EBITDA x 5 =	$5,000,000
Less: $500,000 FMV Assets =	($500,000)
Goodwill (90%)	$4,500,000

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How Risks Impact Value

This relates risk to a value created by earnings. If you have two companies both with an EBITDA of $1,000,000 and one has an asset value of $2,500,000 and the other has an asset value of $500,000, would the price be the same? Maybe, but most buyers will evaluate this risk of loss. If the businesses ever failed there is a greater risk with the company that has only $500,000 in asset value. With the $500,000 company, there would be few, if any assets remaining to cover the buyer's loss. Whereas with the business with the greater asset value. A new owner could recover some of their investment from the sale of $2,500,000 tangible business assets. Generally, this is why a value cannot be created strictly from the economic feasibility of a multiple of EBITDA until the asset value is related to the earnings value.

Financing may also be a factor here. The amount of assets can determine how "bankable" a transaction can be. The more assets included in a sale the more available funding may be.

There are additional variables such as industry, government regulation, economic conditions and competitive position that can affect the valuation of a privately held company. We have found that buyers will use the Economic Feasibility Method as a first step when determining the value of a privately held company.

The fourth and final step is to determine owner's equity or value of the stock. The following data gives a value for the business and the corresponding value of all of the issued and outstanding shares of stock or the stockholder's equity. This would be like a house where the fair market value is $100,000, yet due to a mortgage (liabilities) in the amount of $30,000 the owner's equity (or value of the stock) is actually $70,000. The established business value and corresponding owner's equity (value of the stock) is set forth in this manner.

Therefore, now that the value of the business has been established, the factors that were deleted in the recast of the balance sheet for valuation purposes will be inserted back into the valuation analysis to determine the value of the stock or the owner's equity in the business.

Sample of Business Value to Equity:

Balance Sheet Recast Adjustments Factored Back Into Analysis	
Estimated Enterprise Value	$5,000,000
Example:	
Add Backs:	
Plus: Cash	$200,000
Plus: Real Estate	$550,000
Plus: Non Operating Assets (Condo, Motor Home, ect.)	$150,000
Subtract:	
Less Current and Long Term Liabilities	($2,550,000)
Final "Street Value" of Stock/Stockholders Equity	$3,350,000

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How to Dramatically Boost Your Company's Valuation

When looking at enterprise value and using a base multiple of 5 times EBITDA to establish the base valuation, if you are able to increase revenues by 2.5% and decrease cost of goods by 2.5%, you can nearly double the earnings value of your company. For every dollar that you're able to drive to the bottom line it is worth five dollars in the valuation of your company.

Summary

Remember that this is a very basic way to establish a valuation for your business and is one that can allow you to do a valuation every year to determine if you and your management team are driving the enterprise value of your company in the right direction.

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Brent Freeman brings 30 years of Senior Management experience in the Financial Services industry to Piper Group International. Prior to joining PGI, Mr. Freeman served as Chief Operating Office for NestWorth Inc., a closely held real estate investment company located in San Francisco California. Mr. Freeman has held Senior Management level positions at Bank of America, ITT, GMAC and GE Capital. Having served on acquisition teams for Bank of America, GMAC and having personally bought, built and sold several business, Mr. Freeman brings his extensive personal, corporate experience and expertise to the purchase and sale of middle market business interests.

Mr. Freeman holds a Private Pilots license and he and his wife Mary, own and operate La Dolce Vita Vineyards, Inc.

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Mergers and Acquisitions

Piper Group International has been providing M&A advice to our clients on a national and international basis for three decades. Our unique combination of professionals with deep industry expertise and extensive transactional M&A experience enables us to deliver a consistently high quality of strategic advice and M&A execution to our clients. We specialize in the middle market for both publicly traded as well as closely held companies.

Our capabilities include:

- Acquisitions
  - Sell Side
  - Buy Side
- Exclusive sales and divestitures
  - Divisions
  - Product Lines
- Fairness opinions
- Management buyouts
- Consulting

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Additional insights and value from leading authorities in their areas. Articles in the January, 2011 publication:

How to Attract Significantly More Customers — **Mark Paul**
Do you have all the customers you need? Are you open to new ideas and ways of looking at customers-attraction? If so, you will want to read this article.

Don't Be Blindsided By Financial Risks — **Patrick Wheeler**
What keeps you up at night? Have you been surprised by financial hiccups? This article shares six steps and a case study to help you mitigate financial risks - to help you grow your business.

Create High-Performance Teams — **Tom Cox**
Some CEOs don't need coaching because they are perfect. For the rest, this article discusses reasons why to embrace coaching, how you've already done it, and how to do it even better.

How to measure the business value of technology - Scorecarding — **Manoj Garg**
Do you know if you are truly getting value from your IT investments? Is it difficult to articulate IT's value in your organization? Learn how you can use the IT Value Calculator to figure out how well IT is performing.

How to give a Really Bad Speech — **Dave Yewman**
If your speech doesn't have an unmistakable point; If you never practice out loud; If you never tell stories; you're boring your audiences to death. If you recognize you &/or your team in this article it's time to take action.

Sales Strategy-the Most Critical Element of Corporate Strategic Planning — **Bill Etheredge**
Are revenues tracking to your annual plan? Are you constantly looking for that elusive "world class" sales executive? This article shares how you can boost sales by integrating sales with your strategic planning.

The Urgent Role of HR in M&As — **Iris Sasaki**
Fully 70% of M&As fail to create shareholder value. It is crucial to look at all the possibilities that lead to success.

Paralysis by Analysis: How Development Schedules Slip — **Mike Miles**
Several factors contribute to schedule problems. Recognizing when it's happening, and acting to minimize the effect are explored in this article.

Finding the Street Value of a Privately Held Company — **Brent Freeman**
Maximizing your company's value requires knowing how the market values closely held companies. This article deals with a straightforward method that CEOs and owners can use to find the "Street Value" of their company.

Balancing process against Creative Freedom — **Gary Chin**
This article discusses one of the biggest challenges companies have in developing new products and/or running projects in a matrixed environment.

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