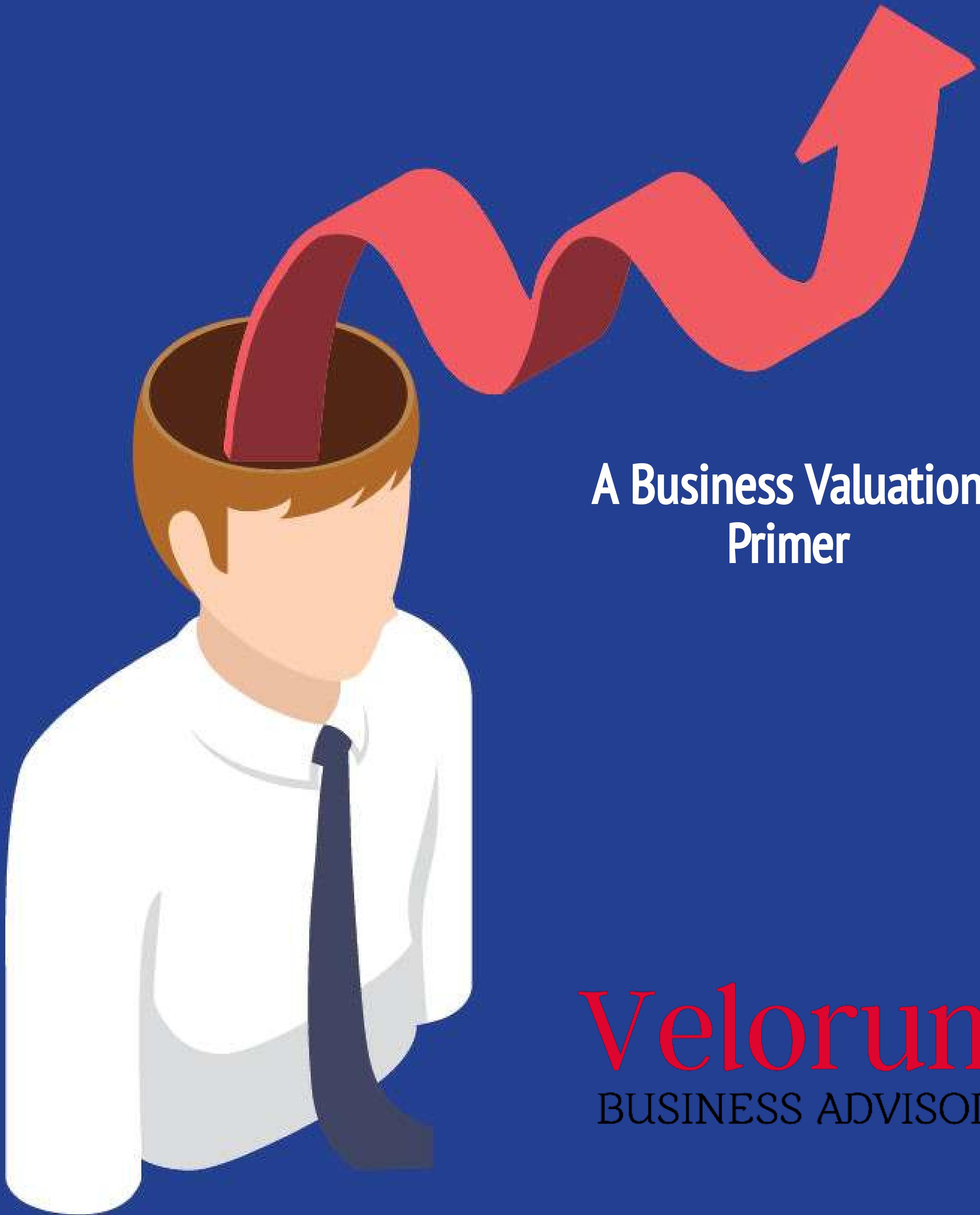
VALUE



A Business Valuation Primer

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BUSINESS ADVISORY

I Introduction

A business valuation is a useful tool for entrepreneurs in many regards. Sometimes there are practical reasons for a valuation to be performed (i.e. to support a transaction). In other cases, it can be a necessary to support litigation matters. Business valuation can also be used as part of your Company's strategic planning. The purpose of this white paper is to provide a brief overview of business valuation that is intended to provide an educational foundation.

II Mercer's Grapes of Value

Chris Mercer, founder of Mercer Capital, described the foundation of business value by creating the concept of the GRAPES of Value. In this case, GRAPES was an acronym that stood for:

- Growth
- Risk & Reward
- Alternative investments
- Present value
- Expectations
- Sanity.

Understanding the GRAPES of Value will help improve business owners' and investors' knowledge of key business valuation concepts. I've summarized them below for you.

Growth--The value of a business takes into account the anticipated growth of the business in the foreseeable future. In general, businesses that are growing fast will have higher multiples than similar but slower growing businesses. One important caveat is that future growth is not guaranteed to happen, so risk plays a role in valuation, also, which we discuss below.

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Risk & Reward--Risk is the possibility an expected result may not be realized. For example, you may expect that your company's revenue will grow by 10% next year but you can't usually guarantee that this will occur for any number of reasons. Risk is usually a key factor in determining a business multiple to apply (or alternatively, a discount rate). When investors take on more risk than with a simple investment (for example, buying a government bond), they expect a higher return to compensate them for the additional risk. The discount rate used in a valuation reflects the necessary return an investor requires to compensate them for the risk they are undertaking. In general, operating a business is riskier than investing in a government bond, so expected returns have to reflect this anticipated risk. Risk and reward are someone individual concepts as well, with each investor likely having their own perception of risk and reward for each situation. Thus, even given the same set of factors, each individual investor may value a business differently.

Alternative investments--Valuation is also based on the concept that individuals are not forced to carry out transactions, and thus can and will consider alternatives. Thus, when a business is listed for sale, if it is priced above what anyone considers to be a reasonable price, it will likely remain unsold, and prospective buyers will seek out alternatives that between reflect their perception of risk and reward.

Present value--Valuation is based on future cash flows, but as we know, a dollar tomorrow is worth less than a dollar today. Thus, value must ultimately represent today's present value of future cash flows. To appreciate this, imagine me saying you can have a million dollar ten years from now, or one year from now. If the money is guaranteed to be paid, then option 2 of receiving the money a year from now is the more valuable option.

Expectations--Despite what most business owner's think, valuation is based on expected financial results not historical. While historical results may guide us as to what we can expect in the future, there are many cases where a company that has done well may be valued poorly if the company is expected to falter in the future (let's say it is operating in an industry in severe decline). In contrast, the company with poor results may be richly valued due to expected high growth in the future.

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Sanity--While on the individual level, emotions may play a factor in how someone might value a business, in the aggregate, sanity must prevail when calculating a valuation. This means that the valuation of the business needs to be aligned with expectation, growth, perceived risk & reward, along with options for alternatives. Investors need an appropriate return on investment over a reasonable period of time. From a buyer's perspective, a business that is priced too high will not offer reasonable returns. Similar, from a seller's perspective, selling a successful business ate firesale prices doesn't make sense either since they are unnecessarily leaving money on the table.

III Standards of Value

A standard of value describes the way in which the value of a business is assessed. There are four main standards of value:

i) Fair Market Value;

ii) Strategic or Investment Value;

iii) Fair Value; and

iv) Liquidation Value.

Fair Market Value is defined in the International Business Valuation Glossary as "the highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." Most business valuations will be conducted at fair market value. In general, fair market value may take into consideration how multiple prospective buyers might analyze a company using the principles discussed above in the GRAPES of value. In Canada, fair market value includes strategic or investent value if it is known.

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Strategic or Investment Value is the value of a business from the perspective of an individual prospective buyer (either a person or a corporation). This is usually the standard applied in M&A advisory work since the risk tolerances and potential synergies of an acquisition will be known with greater certainty. In Canada, strategic value is also considered fair market value, while in the US, they are denoted separately.

Fair Value is the value of the business often used when valuing minority interest shares under shareholder dispute or oppressed shareholder situations.

Liquidation Value is the value of a business that is being wound-up, either in an orderly fashion or a forced fashion through bankruptcy.

For most active businesses, fair market value will be the standard under which their business will be valued.

IV Levels of Value

There are four levels of value that depend upon the size of the shareholding being valued along with the characteristics of those shares. The four levels are:

1. Marketable Controlling Interest
2. Non-marketable Controlling Interest
3. Marketable Minority Interest
4. Non-marketable Minority Interest

In general, the word "marketable" implies there is a ready and active market for such shares. Non-marketable implies the opposite and thus, there may be (and often are) differences between marketable and non-marketable shares.

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"Control" implies a block of shares can effectively run the company through having the majority of votes. In some companies, an individual shareholder may not have a plurality of shares, so an analysis has to be made to assess what shareholder groups have *de facto* control. Minority interest shares are those whereby the individual shareholder does not have enough votes to control the company, although they may have some degree of significant influence. In general, minority interest shares may have discounts applied to them when valued on a stand-alone basis.

Marketable controlling interest shares are often seen in real life M&A deals and there are various databases which track these transactions. An example of marketable minority interest shares is the average common share sold on public stock markets. "Non-marketable" shares, whether controlling or minority interest, tend to relate to private companies for which there is no public market in which shares can be bought. Note that "non-marketable" does not imply that shares cannot be sold to a buyer, but rather there is simply no organized market for such shares.

The valuation assignment will outline the specific level of value used in a report.

V Valuation Methodologies

There are three common valuation methodologies or approaches used today:

Income Approach: The Income Approach estimates the value of a business by analyzing its future income or cash flow potential. It focuses on the present value of expected future earnings, often using methods like Discounted Cash Flow (DCF) analysis. The DCF model forecasts the company's future cash flows and discounts them back to their present value, considering factors like growth rates, risk, and the time value of money.

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Market Approach: The Market Approach determines the value of a business by comparing it to similar companies or comparable transactions in the market. It involves using valuation multiples (e.g., Price-to-Earnings ratio, Price-to-Sales ratio) derived from comparable companies or recent M&A deals to assess the target company's value relative to its peers. This approach relies on the assumption that similar businesses should have similar valuation multiples.

Asset-Based Approach: The Asset-Based Approach calculates the value of a business based on its net asset value. It involves summing up the fair market value of the company's assets (both tangible and intangible) and deducting its liabilities. This method is particularly useful when the value of a company's assets is higher than its expected future earnings, as might be the case with asset-rich businesses or businesses where income has been lower than average.

Each of these valuation methodologies has its strengths and weaknesses, and the appropriate method to use depends on the specific circumstances of the business being valued, the industry it operates in, and the purpose of the valuation. It is common for valuation analysts using their professional judgement to use a combination of these methodologies to arrive at a more comprehensive valuation.

VI Advisory Versus Independent Valuations

Valuations can be performed on either an independent basis or an advisory basis. Independent valuations are often used for tax valuations, shareholder disputes, litigation, or where multiple stakeholders may be using the report. Valuations may also be performed on an advisory basis whereby the valuation analyst is not necessarily independent but rather advising one party over another in terms of valuation. This is most commonly seen in M&A deals.

VII Common Uses & Benefits of Valuations

Valuing a business is a critical process that provides numerous benefits for both the company and its stakeholders. The key benefits of valuing a business are:

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1. **Informed Decision Making**: Business valuation provides essential information about the company's worth, enabling informed decision-making for various scenarios, such as mergers, acquisitions, divestitures, and internal restructuring.
2. **Transaction Guidance**: For businesses involved in buying or selling activities, valuation helps set a fair and appropriate price, facilitating successful negotiations and increasing the likelihood of a smooth transaction.
3. **Capital Raising**: Accurate business valuation can attract potential investors or lenders by demonstrating the company's financial health and growth potential.
4. **Shareholder Equity Determination**: Business valuation is vital for determining the fair value of shareholders' equity, especially in privately held companies, where market prices are not readily available.
5. **Estate and Tax Planning**: Business valuation plays a crucial role in estate planning, helping to determine the value of a business for tax purposes, succession planning, and wealth transfer.
6. **Financial Reporting**: Companies might need to value their business for financial reporting purposes, such as complying with accounting standards, impairment testing, and goodwill evaluation.
7. **Partnership Dissolution**: In cases where partnerships dissolve or partners exit the business, valuation can help ascertain the fair value of their interests.
8. **Litigation and Dispute Resolution**: Business valuation is often required in legal proceedings, such as divorce settlements, shareholder disputes, and other legal matters.
9. **Benchmarking**: Valuation helps a company compare its value with industry peers, enabling better benchmarking and identifying areas for improvement.
10. **Strategic Planning & Value Creation**: Business valuation provides insights into the company's strengths and weaknesses, assisting in the development of strategic plans and growth strategies.
11. **Employee Incentive Programs**: For companies considering equity-based employee incentive plans, valuation determines the value of the shares awarded to employees.
12. **Financial Health Assessment**: Valuation can serve as a tool for evaluating the company's financial health, sustainability, and long-term viability.

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13. **Exit Planning:** Valuation can help business owners plan a business transition through identifying key value drivers in the businesses and in conjunction with a strategic plan, grow the value of the business before an eventual exit.

Overall, business valuation is essential for a wide range of purposes, guiding critical decisions, providing transparency to stakeholders, and facilitating smooth operations and growth for the company. It helps bring clarity and understanding to the company's financial position, aiding in strategic planning and successful business management.

VIII Value Creation

Value creation is the act of increasing the value of your business through a two-step process: i) improving the company's value drivers over time, and ii) de-risking the business. Every business has value drivers, some of which may be unique to your industry and others which universally apply to all businesses. The six key value drivers are:

1. Finance--Can you forecast your financials? Do you understand what they mean?
2. Operations--Do you get goods/work products out the door on-time and at expected costs?
3. Revenue--Can you bring in revenue on a repeat basis? Is your customer base diversified?
4. Human resources--Can your business run without you? Do you have a team which supports your overall organizational goals and objectives?
5. Organization--Is your organization structured effectively to support your corporate goals? How do cultures, purposes, and values play a role in the running of your organization?
6. Market Position--Are you an industry leader, average, or a laggard? Is your industry growing, mature, or in decline?

By putting resources into improving each of the above value drivers, business owners can put together a structured plan to increase the value of their business over time. INcreased value can not only increase owner wealth but also provide an owner with additional choices for an eventual transition or exit.

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In this white paper, we explored the fundamentals of valuation along with the concept of value drivers. Business valuation is a useful tool for entrepeneurs and should be incorporated as part of their long-term business strategy.

Interested in finding out more about having a business valuation done or ways to improve the value of your business? Contact Velorum Business Advisory at david@velorum.ca or 905-337-8341. We'd be happy to have a complimentary discussion with you.

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