Valuing Your Business in Connection with a
Prospective Sale, Investment or Financing

How is Business Valued?

There are several methods for valuing a business, many of which are used in combination. As a starting point, industries frequently have their own rule of thumb to calculate a rough value based industry averages and/or published standards, generally expressed as a specific "multiplier" (e.g., three times sales, a multiple of turnover, etc.). More analytical valuation methods include:

- Discounted cash flow ("DCF") - Estimates of the business' future cash flow over a period of 5 to 10 years, adjusted based on a discount rate applied to outlying years. The analysis takes into account factors that may change and influence future cash flow over time, such as an owner no longer being involved in the business or new products in development. Preparation of projections for the DCF is an art, based on historical performance and other specific assumptions. The resulting value is sensitive to the discount rate used. The DCF is most useful for businesses with stable, predictable cash flows.

- Multiples of Earnings – Profits are adjusted to eliminate non-recurring factors, such as exceptional costs or any changes that may occur after the sale, to estimate sustainable earnings. The valuation then is calculated as a multiple of earnings, which is based on industry standards, size of business and growth prospects. This is used for growing businesses with a profitable track record.

- Appraisal or Asset Valuation – An appraisal looks at the net book value of a business – its total assets less its total liabilities. Adjustments are made to reflect current values, as well as any changes to the business a buyer is likely to make (e.g., selling off assets, buyout payments to be paid to employees, etc.). This method does not take into account the company's intangibles, such as good will, or business performance. As such, it does not accurately reflect the total value of a business. This analysis is used for businesses with high levels of assets or unprofitable companies with poor growth prospects likely to be wound up.

Consult with an expert appraiser or business valuation firm to determine the best approach for your particular needs and industry.

What should a business owner do if they want to sell and plan on getting a valuation? How can a business increase their value before a valuation?

- Consult with an experienced business lawyer to discuss and assist with the steps to prepare your business for sale or investment/financing. (Warshaw Burstein, LLP and its attorneys advise clients regularly on these issues.) If possible, preparations should begin three to four years before you anticipate looking to sell the company, because most buyers will want to see three years of financials.

- Consult with your accountant and an experienced business valuation expert.

- Conduct a baseline valuation to get a general sense of the company's worth, and then strategically – considering a buyer's perspective to the extent possible - take steps to solidify your profit record, reduce your business risk and improve your valuation in the years leading up to offering your business for sale. For example:

- Stop or back-out transactions with, payments to, or assets of, owners, officers, family members and affiliated companies, and generally clean up the balance sheet;
  - Pay down debt, if feasible;
  - Clean up potential liabilities and legal problems/litigation;
  - Sell off unproductive assets and inventory, replace outdated equipment;
  - Diversify customer base;
  - Groom potential successors, and consider whether to lock-in key employees;
  - Protect important trademarks and patents;
  - Recast financials (pro forma for adjustments made, changes during the three-year period, capitalized vs expensed costs, etc.) and have three or more years of audited financials;
  - Put strong financial and management systems in place that provide confidence in the company and its results;
  - Evaluate your business compared to industry average financial ratios;
  - Market products and services in a way that may attract potential purchasers; and
  - Identify opportunities to increase profits (cut costs, identify new markets/products to improve growth prospects, identify opportunities for cross-selling to potential buyer's customers, etc.).

- Try to time your sales process for when business conditions are favorable, valuations higher and financing costs lower, even if sooner than you might have planned. If you are not under pressure to sell, you'll be in a stronger negotiating position.

- Think about how to structure your company and potential sale in a tax-effective manner, or how you might close the gap between your valuation expectations and those of a buyer. For example:

  - Remaining with the company as an executive or consultant;
  - Accepting an earn-out for part of the purchase price payable over a year or two after sale; or
  - Deferring payments of the purchase price over time, or accepting buyer equity in lieu of some portion of cash consideration.

- Engage a business broker or investment banker to advise and assist with sales process and help identify potential prospective buyers.

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If you are considering selling or financing your business and anticipate needing a valuation or other advice, please call any of the undersigned or your regular Warshaw Burstein attorney.

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