

Valuing and Selling Your Business

A Quick Guide to Cashing In



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Introduction

A quick guide to cashing in! It would be awesome if selling your business and living happily ever after was quick and easy. It is not. Do not let the subtitle of the book fool you. The subtitle is in reference to the type of book this is rather than how easy it is to value and sell your business.

This book is written to the business owner that wants a quick read about the valuation and selling process in an easy-to-read format. My goal is for you to be able to know how your business is valued, be aware of ways to grow that value, and understand the selling process in less than four hours.

My ideas are intended to be understandable, straightforward, and direct. This book is not written for the professionals who serve the business owner but it is written directly to you—the business owner.

If you want to maximize your personal wealth it is important that you understand the valuation and selling process.

There are two disturbing trends that I see with many of my clients. The first is a major disconnect between the actual business value and the owner's perception of that value. The second trend I see is that, even though in most situations a business owner's largest financial asset is his or her business, he or she does not view it as an actual asset or investment. My clients when they come to me have been spending considerable time and money with their investment advisors growing their stock and bond portfolios, while putting no effort into knowing and growing the value of their largest assets—their businesses.

Once I noticed these trends, I started to recognize the major consequences that the business owners were having in not treating their businesses as investments. I was convinced that if business owners simply changed their mindset and started to treat their businesses as investments, they would have a greater sense of purpose and become wealthier. This discovery started my journey of preaching to all business owners that they need to treat their businesses as investments. Treating your business as an investment includes knowing its true value, having a plan to grow that value, and understanding how to realize the value that is in your business through a sale. If you can walk away from this book fully understanding the valuation process, knowing how to increase the value of your business, and understanding the selling process, then reading this book was well worth your time.

I cannot guarantee that reading this book will double or triple the value of your business in five years. The business world is complex, and you obviously don't have total control of your destiny. You can take all the advice in this book and still not have things turn out the way you want. However, when you gain knowledge and take action, your chance of being successful increases.

I derived and adapted this book from a self-standing portion of my previous book, *Know and Grow the Value of Your Business: An Owner's Guide to Retiring Rich*. In *Valuing and Selling Your Business: A Quick Guide to Cashing In*, I focus on selling one's business as an exit strategy—to the exclusion of the various other exit strategies covered in my longer work, such as gifting to the next generation, retaining the business, and liquidation. In addition, my previous book includes more in-depth discussion about treating your business as an investment, more decision-making tools, and more examples. If you are unsure of what your exit strategy should be and what your full range of options is, please read *Know and Grow the Value of Your Business*.

The appendices in the present book detail what is required in a valuation report and show you samples of the documentation that buyers will request from you when you sell your business. Although this book was not written to make you a valuation expert, you will find it instructive to see what is included in a valuation report. This is why I've included an excerpt of the AICPA business valuation standards. In case you need to have a valuation prepared for a third party such as the IRS, the AICPA excerpt in the final appendix provides reporting guidelines for business valuations and a comprehensive glossary of terms.

The sample due diligence request in the appendix will also be of great benefit to you. It gives you a head's-up of what your potential buyer will request and serves as a checklist to make sure you assemble all the proper documentation and items that you will need for a buyer.

Thank you for picking up this book. After reading it, you will look at your business differently, I hope—seeing it as your most important financial investment. Finally, my fervent wish is that it helps you to “cash in” on the many years of blood, sweat, and tears you have put into your business!

Country Club Lifestyle

Do You Know Your Value?

A sophisticated businesswoman in her sixties called me late one summer afternoon. “Mr. McDaniel, I would like you to value my company in order to complete a transaction with my nephew.” We spoke further and arranged a meeting for the following week. When I arrived at her company, I noticed how nice the furnishings were. It had the appearance of a very successful company. She provided me a tour and explained how the company started, her role in the business, and other relevant facts that were needed to prepare a business valuation. She explained to me that she was selling the business to her nephew, who worked in the company. He was in his late twenties and had been in the business for about six years.

I had seen numerous engagements like this one—a client wanting to use an independent valuator to set the price between related parties. It is required by the Internal Revenue Service (IRS),¹ and it often saves some bad blood between relatives down the road.

However, I was very surprised to find out that this engagement was different. When I asked her if my services and valuation report would be used to set the purchase price, she replied, “Oh no, the price is set. We just need a valuation report in order for my nephew to obtain a bank loan.” I asked,

¹Transactions between related parties need to be at “fair market value,” or they may be considered a gift by the IRS and thus taxable.

“What is the price?” She said, “\$2.5 million.” I continued, “How did you determine that price?” Without hesitation, she said, “This is the amount I need to support my country club lifestyle. I belong to an exclusive country club and if I obtained \$2.5 million, I will be able to maintain my membership at this club and live the lifestyle I want.” I was stunned by her answer. At that point in my career, I had been involved in more than 1,000 valuation engagements and never had a client provide an answer like that.

I proceeded with the engagement and determined that the company was worth significantly less than her expectations. It was my opinion that the company was valued at about one-third of her expectations—only \$800,000. Besides the \$50,000 salary that the nephew received from the company, he had no other financial resources and no bank would provide him with an \$800,000 loan, let alone a \$2.5 million loan.

How could this very smart businesswoman be so wrong? Why did she wait until she was in her sixties to find this out? Unfortunately, to maintain her country club lifestyle, she would have to continue working or find a fool who would grossly overpay at \$2.5 million.

Her compensation from her business was \$250,000, enough to provide her with the lifestyle she wanted. There was only one catch. She had to go to the office each day and work hard to make sure that her customers were happy, the employees were doing their jobs, and the bills were paid. If she would have sold her business at the true fair market value, she would have received close to \$600,000 after paying taxes and transaction fees. Like most business owners, her business interest was about 75% of her net worth. With her spending habits, the proceeds from the sale of her business would provide her with the lifestyle she wanted for only a few years.

While no one had ever told me they arrived at a price based on the country club lifestyle they desired to have, the details here are commonplace. Business owners guess at what their business is worth (their most important asset), and they typically guess wrong. Unfortunately, their guesswork leads to undesirable consequences such as:

- Being unable to retire at the lifestyle they expect
- Working more years than they had hoped
- Choosing the wrong time to sell their business
- Not being able to exit their business on their own terms

What if the client had known that her business was only worth \$800,000 when she was 55 instead of 63? She could have implemented strategies to increase the value of her business and then lived the lifestyle she wanted.

Alternatively, she could have changed her lifestyle to fit the actual proceeds she would receive when she sold her business. But now, it was going to be very difficult for her to remedy the situation at age 63.

■ **Important** There are major consequences to you and your future in guessing wrong at the value of your business.

Treat Your Business Like an Investment

The majority of the net worth of most business owners is tied up in the value of their business. It is their most important investment, but it is rare that they view it this way. Business owners spend more time and money managing liquid assets (stocks, bonds, and mutual funds), which are easy to value and do not have the large potential for growth like their business does. Typical business owners do not view their business as an “investment.” It is more of a “piggy bank,” “identity,” or “a job.”

Treating your business as an investment is critical for you to accomplish your long-term financial goals and increasing your net worth.

Your business is no different than your other investments. Small changes in the annual rate of return will have a large impact on the future value of the investment. The major difference between your business investment and your other investments is that the business is a much larger part of your overall net worth. Growth in the value of your business will have a greater impact on your net worth than the growth in your other investments. Consider this example.

Elle owns a business, and she has a total net worth of \$5 million. Her net worth consists of the following assets:

- Value of the business: \$3 million
- Marketable securities: \$1 million
- Real estate and other assets: \$1 million

She reads the *Wall Street Journal* on a daily basis and has quarterly meetings with her investment advisor to discuss her marketable securities portfolio. Her goal is to earn a 7% annual return on her marketable securities over the next ten years and then retire. If she achieves her goal, the securities will be worth \$1.97 million. If there is no growth in the value of her business and other assets, her net worth would grow to \$5.97 million.

Now let's assume that she is also focused on growing the value of her business at the same 7% rate over the next ten years. If she achieves her goal, the business will be worth \$5.90 million. If both the business and marketable

securities investments grow at 7% annually, her net worth would grow to be \$8.87 million in ten years.

By focusing on growing her business along with the value of her securities, Elle's net worth will be \$2.9 million higher ten years from now.

How can you treat your business like the important investment that it is? In order to treat your business like an investment, you must take the following steps:

- Know the true value of your business.
- Have specific plans to increase its value.
- A plan to realize value "cash in" through a sale of the business.

Your business is every bit as much an investment as stocks, bonds, and mutual funds. Treating your business like an investment is the key to increasing value and building wealth.

Most business owners have a vague sense of the selling price for their business. It is usually in terms of the amount they believe they need to live the rest of their lives comfortably without working. Not much thought is given to who the best buyer for their business is and when is the best time to sell their business. These business owners usually sell their business at a price much lower than they anticipated and at times are forced to sell their business due to life circumstances,

I have met very few business owners who actually have specific written plans to grow the value of their business and know the importance of having their business in its sellable position at all times in order to provide them with the best opportunity of selling their business at the right price and the right time. The business owners that actively work these specific plans are able to move on to their next phase of life on their terms.

Summary

It is critical that you actually know what your business is worth. Guessing at its value based on your personal needs will lead you down the wrong path. It is important to have an "investment mindset" towards your business. It is your most valuable asset and, by focusing on growing this asset and having a plan to realize value from a sale, you can increase your net worth significantly.

In the next chapter, you will learn more about what a business valuation is and who is qualified to prepare one. By the end of Chapter 4, you should have a solid understanding of the entire business valuation process and how to increase the value of your business.

Valuation Fundamentals

Valuation in Plain English

“I don’t want to pay that much for a valuation,” the caller said. “Can’t you just put my numbers into the computer and spit out my value? I just want something quick and dirty.” This is an all-too-common conversation that I have with potential clients. The truth is, there’s no such thing as a quick valuation, and there’s no (reputable) computer program that can provide an accurate valuation based on a bunch of numbers you input.

In this chapter, I will explain the entire valuation process by using everyday language. So if you are a valuation professional, please forgive me for not using the specific nomenclature that you are used to.

Let’s look at a real-life example that shows why a good valuation depends on much more than looking at only financial records. There is a national parts distributor that buys products directly from manufacturers and then processes and repackages the products and delivers them to the retailer. The retailer then sells the products to the consumer. Historically, the distributor’s revenues have been over \$100 million and the annual profits have been consistently over \$4 million.

How much is this business worth? Should it be based on a percentage of revenues? How about a multiple of earnings?

The actual value of this business is less than \$1 million. How can this be? Based on historical earnings, you would earn the purchase price in three months. What a bargain! Interested?

The rest of the story is that the distributor is very dependent on one customer. That customer accounts for over \$90 million (or 90%) of the \$100 million in annual sales. They recently lost the customer and may liquidate the business rather than try to rebuild it. After selling the company's assets and paying off all the company's obligations, the owner believes that he will be able to put just less than \$1 million into his pocket. This process will take a couple of years.

Would you get the right answers if you simply put numbers into a spreadsheet and based the value on historical earnings? Absolutely not! Why? It's because of the following point:

■ **Important** Valuation is a prophecy of the future based on the information that the valuator has as of the valuation date.

If someone has prepared a valuation for you by using a canned valuation software program without interviewing you and without understanding your business and industry, please take the valuation report and throw it in the trash. It's not worth your time.

The valuation process is a mystery for most business owners. Web sites, articles, and books like this one can shed light on the mechanics of placing a value on a business and will provide you with some education on how to value a business. However, the terms used in many of these resources makes the valuation process seem more complex than it actually is.

Some business owners will hear stories from their friends or read articles about how much money others have received from selling their business. "It was simple," says the friend. "They gave me five times earnings." This makes the valuation process seem easy.

The reality is that the valuation process is much more involved than multiplying an earnings number by a multiplier, but it is not so complex that you cannot understand it.

Hopefully after reading this chapter, you will have a basic understanding of the valuation process and be able to explain to your spouse in plain English this process. You will also know the difference between *enterprise value*, *equity value*, and the *net proceeds* that you receive after you sell your business. The discussion is still more of an overview, but a necessary one. In the next chapter, we will dive in deeper and provide more of a "how the sausage is made" explanation of the valuation process.

What Is a Business Valuation?

A business valuation is a process and a set of procedures used to estimate the value of an owner's interest in a business. The key words in this definition are process, procedures, and estimate.

A long-standing resource that describes business valuation and the important factors in the valuation process is IRS Revenue Ruling 59-60 (usually known as 59-60). When it was introduced in 1959, 59-60 was the most important resource in determining how to value a business. It has stood the test of time and continues to provide a guide to business valuers on how to prepare a valuation for the IRS and for other purposes. The following is a key excerpt from 59-60:

Valuation of securities is, in essence, a prophecy as to the future and must be based on facts available at the required date of appraisal.

Let's break down this definition further. Valuation is an estimate of value. Of the 2,000+ valuation engagements that I have been involved in, there have been only a handful of times that an actual sale of the appraised business occurred within a few months of the valuation date. Almost 100% of the time, I had no verification of how close my estimate of value would be to reality. In part, that's because many are done for estate planning purposes, divorces, and other efforts that do not involve the sale of the business.

I'll be the first to say that valuations are subjective. The IRS concurs, to a degree. The opening paragraph of 59-60 states the following:

In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods, and factors which must be considered in valuing such securities are outlined.

How do you know if the conclusion is correct? Unfortunately, you don't. And this is where the next part of the definition is important. *There are recognized processes and procedures that are standard in the business valuation industry.*

Therefore, a business valuation is much more than simply putting numbers into a spreadsheet and spitting out a number. If a valuation is an estimate based on a prophecy of the future, how is this done? With a crystal ball? Dartboard? Truthfully, these may provide you with more insight than an analysis prepared by untrained professionals using computerized software.

Before we dive into the recognized processes and procedures of a business valuation, let's discuss the business valuation profession and when a business valuation is needed.

The Valuation Profession

When you need a business valuation, where should you go? To your CPA who prepares a few valuations a year, aided by his latest and greatest software program? To an Internet provider that promises you cheap and fast valuations? Or what about those professionals who travel around the country leading slick seminars that will get you all enthused about selling your business? Of course, those “professionals” also want you to sign up for only a \$55,000 business valuation to start the process.

So how do you decide who will prepare the valuation of your business?

Business valuation has become its own profession. There are four major professional organizations that provide training and accreditation to the business valuation profession. For each one, the accreditation process includes testing on valuation theory and standards, submission of work product, and an experience requirement. Some designations are harder to obtain than others (e.g., ASA); however, if someone has a designation from one of the following four organizations, you can know that the valuator understands the recognized processes and procedures used in a business valuation:

- ASA (Accredited Senior Appraiser) by the American Society of Appraisers
- ABV (Accredited in Business Valuation) by the American Institute of Certified Public Accountants.
- CVA (Certified Valuation Analyst) by the National Association of Certified Valuators and Analysts
- CBA (Certified Business Appraiser) by the Institute of Business Appraisers

A business valuation incorporates many different disciplines and requires the valuator to have a variety of skill sets. Valuers or their teams need to be familiar with the following in order to produce a credible business valuation:

- Know how to read financial statements and understand accounting theory.
- Understand how income taxes impact value.
- Know the relevant tax codes and court cases on valuation issues.

- Be able to perform robust financial analyses.
- Understand how the economy will impact a business's cash flow.
- Have a firm grasp of valuation theory and be able to apply the appropriate valuation methods.
- Be able to research complex issues.
- Know how publicly traded stocks are valued.
- Be able to communicate the results of a valuation to a business owner, a judge, or the IRS.

In addition to these skills, the valuator needs to apply “common sense” and be unbiased. At the end of the day, the valuator should step back and ask the question: “Would I buy the business at the price I valued it?” At times, it is clear to me that a valuator's conclusion is not remotely close to the actual value. This is typically due to a valuator's lack of knowledge or experience, or a decision to provide a biased opinion of value. At times, business valuers can become advocates and manipulate the results in order to please their client.

It will be difficult for you to determine the skill and the common sense of the business valuator. So how do you objectively hire the right person for you? Of course, I am biased, but I suggest that you look for the following when hiring a business valuator:

- It should be a full-time profession and not something they do occasionally to supplement their income.
- They should have at least two designations from the organizations listed previously.
- Experience is a critical factor, similar to choosing a surgeon. You don't want your company to be one of the valuator's first projects. You should select someone who has been involved with hundreds of valuation projects.
- They should be able to explain complex business issues to you in plain English. They should also be willing to sit down with you and your family members and explain how the valuation was prepared and why they chose a certain conclusion. You want someone who enjoys teaching clients about the valuation process.