Business Valuations: Measuring Your Pot of Gold

Given that most music retailers aren't earning a king's ransom in salary, they're generally content to make a decent living in their business of passion. In fact, most music retailers expect to grab their pot of gold after they retire and sell their business.

Unfortunately, history teaches us that many business-sale transactions wind up being lopsided with either over-inflated sales prices or assets purchased at bargain basement prices.

Remember 1683, back when you were just a kid? The Manhattan Indians sold the Island of Manhattan to the Dutch West India Co. for a whopping $24 worth of trinkets. In 1867, the Russians sold Alaska to Secretary William Seward for $7.2 million (the equivalent of 2 cents an acre). And let's not forget 1971. That's the year I traded a pre-CBS Fender Telecaster and black-faced Super Reverb amp for a 1970 Strat at my local music store (guess who got the better end of that deal...D'oh!).

If the Indians, the Russians and I had performed a proper valuation of our business assets, Wall Street would be in Hackensack, King Crab Legs would come from Boise, Idaho, and I would have been the next Hank Williams.

So what is a business valuation? When is it necessary? How are they done? Are they accurate? Are they reliable? Are they expensive? Are they worthwhile? Will these questions ever stop?

What It Is, Brother

Business sales, mergers, estate planning, divorce, shareholder disputes, buy/sell agreements, employee stock option plans, economic damages...these and other circumstances often require a valuation of a business that presents an accurate, comprehensive analysis of the assets owned and liabilities owed. The "value" of a business is determined, in dollars, by assessing the financial particulars of a company, as well as the industry in which it operates.

A valuation is often a very complex process, and if not performed thoroughly, the parties involved could be misled into believing the company holds a value dramatically different from its true value. These faulty valuations can cause a potential buyer to pay far more than the business is worth, leaving no chance for financial success. It can also cause a potential seller to part with their company for far less than its worth, leaving years of hard work unpaid and a lucrative retirement lost to the new owner's benefit.

Therefore, a well-informed business owner and an experienced, objective, well-trained business valuation expert are critical to assessing the true value of a business, and assuring the proper outcome of any transaction relying on that value.

Recent Small Business Trends

Here's some interesting business statistics that have given rise to the recent increase in the need for business valuation engagements:

#1: Ninety-percent of American businesses are closely-held.

#2: There are more than 20 million small companies in the American economy, employing two out of every three taxpayers.

#3: Approximately 14 million of these small businesses are family-owned. Seventy-percent of these businesses will fail to make the transition to a second generation of family ownership, and of those that do, less than half will make it to the third.

#4: Small businesses produce 39 percent of the Gross National Product and provide more than half of the nation's technical innovations.

#5: The small-business marketplace continues to experience tremendous growth and activity due to a number of factors, including (a) a proliferation of business start-ups, (b) downsizing of larger businesses resulting in formation of businesses by departing executives, (c) increased financing opportunities for small businesses, (d) acquisitions, mergers and sales of closely held businesses and (e) establishment of Employee Stock Ownership Plans.

Accordingly, these business trends and recent increases in litigation from shareholder disputes, divorces, business damages and estate taxation issues have created an insatiable need for qualified business appraisers to perform valuation engagements. Let's take a look at how a business valuation can help a typical music store owner.

The Tired Music Retailer Wants to Cash Out

Business valuations are performed in a broad spectrum of situations. To illustrate both the need and the subjective nature of business valuations, let's consider the plight of music retailer Shecky Schnitzle, owner of Shecky's House of Rock and Schlock ("SHRS"), located in Schenectady, N.Y.

Shecky has been in the music product retailing business for more than 40 years and has seen some great times. But lately, business has been rough. Maybe it's because Shecky is 67 years old; maybe he's tired of the seven-day-a-week retail grind; maybe he's tired of fighting big box and internet retailers. Whatever the reason, Shecky's tired and wants out of the business.

Shecky's not the only one who's tired. His employees are tired of years passing by with little increase in compensation and little opportunity for advancement. And Shecky's wife is so tired of him being an absentee husband and father that she's filed for divorce. Basically, Shecky is fried to a crisp.

One of Shecky's competitors (Morty Martian, owner of Morty's Music Mart located 30 miles away) made Shecky an offer of $500,000 for his business. Shecky doesn't think that's enough and wants to sell his business to his employees for $1 million. Of course, Shecky has told his wife's divorce attorney the business is worthless. Of course, the attorney thinks the business is worth more than $2 million.

Well, with a range in value from $0 to $2 million, it should be pretty easy to determine the true value of SHRS, right? Wrong.

The Subjective Subject of Value

Valuing an ongoing business is probably the most subjective task undertaken by financial advisors in today's business world. Unlike accounting, taxation and finance—which all have well-defined rules, standards, guidelines and formulas—business valuations are subject to differing opinions on (a) valuation approaches, (b) interpretation of its financial, market and economic data as well as (c) use of capitalization rates, discounts, adjustments and rates of return. Is it possible for two different business professionals to value Shecky's at $0 and $2 million respectively? Absolutely, yes! Is it possible they're both right? Absolutely, no!

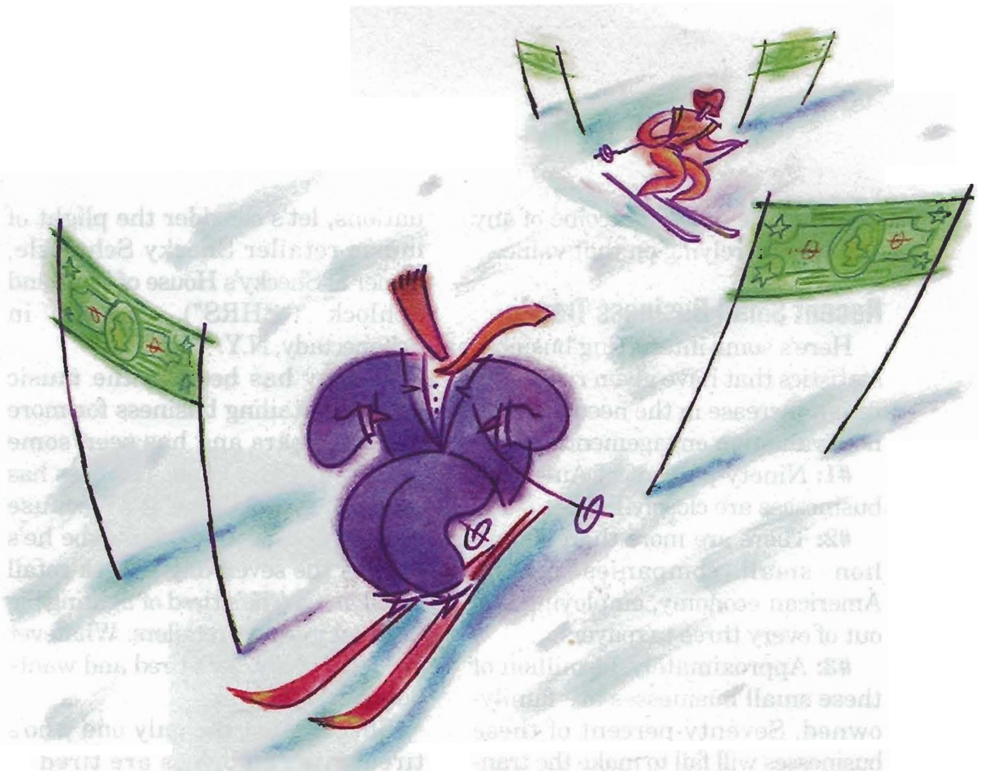
There are a few different approaches to determining the value of a business and its assets, depending on how you define "value." Value can be expressed in a variety of terms such as "fair" value, "fair-market" value, "investment" value or "liquidation" value. Business valuators need to identify and determine the most appropriate standard of value for the valuation engagement—although most owners seek a business valuation based on fair market value, which is defined as "the price at which the property would change hands between a willing buyer and a willing seller when neither party are under any compulsion to buy or sell and both parties have reasonable knowledge of the relevant facts."

The business valuation process is subjective since every business is unique. No one method or set of methods is right for all situations. A qualified, experienced valuation expert must interpret a company's business and financial information correctly to arrive at a correct method and defensible value.

Science or Art?

Business valuations are often viewed as a combination of science and art. To be supportable, a business valuation should be based on systematic, scientific approaches to gathering analytical facts about the business and communicated in a well-documented valuation report that includes financial and legal facts about the company as well as the economy and industry it operates within. Unfortunately, the business valuation process is not an exact science. The valuator must appropriately apply insight and methodology to identify, address and quantify all components of value—many of which are intangible.

Numbers, facts, figures, balance sheets and financial statements alone are not accurate measures of the true fair market value of a company's assets. There is much more to the process of determining value. Different approaches and methodologies—along with various analysis, economic and market analysis, mathematical calculations, ratios, industry comparisons and business risk assessments—are needed for a competent valuation of a business.



Which Approach?

One common approach to valuing a business involves measuring its earning power and capitalizing it. This determines the value of the business to an investor, based on the future returns that they can reasonably expect.

For example, a business appraiser can determine value by capitalizing net income, pretax income, income before interest and taxes or any other earnings base. The capitalization rates they use will differ depending on the earnings-base used. Determining the correct rate, however, is the key to finding a meaningful value. No matter how valid the method of valuation, using an inappropriate capitalization rate can render the results meaningless. Therefore, the ability to choose an appropriate capitalization rate is essential.

How to Select an Appraiser

When you choose a business appraiser, make sure to choose one with qualifications and experience in valuing music retailers. Given that many valuation reports will come under scrutiny (during an estate tax audit, a divorce hearing or in litigation if a new business owner paid too much for an over-valued business), it's important to look for certain business valuation qualities in your appraiser. These include : professional certifications and credentials, such as a Certified Public Accountant (CPA), Certified Business Appraiser (CBA), Certified Valuation Analyst (CVA), etc.; professional experience in business valuations of music instrument and product retailers; a reputation for trust and confidentiality; professional achievements and affiliations; and membership in professional societies.

Did You Know?

Did you know NAMM provides its members with a resource for business valuations? Through an affiliated trade group called Industry Insights (the same folks who compile NAMM's annual *Cost of Doing Business Report*), you can submit your company's financial statements and receive a cursory assessment of its value. The service costs less than $500 and provides you with a report that shows the value of your business, using an appropriate valuation methodology. This is a great service for store owners interested in having an approximate value for business planning purposes. But remember, this report is not designed to withstand the scrutiny of an estate and gift tax audit, a court-ordered valuation for divorce purposes or legal proceedings rising from shareholder disputes. Those reports (the subject of this article) are more than 50 pages long, with detailed market and industry analysis, financial and economic data assessments and can easily cost $5,000 to $10,000, or more.

Some Final Thoughts

Remember, independence is a primary reason for engaging a business valuator. Problems involving a lack of independence, fairness, competence and disputes among interested parties can be avoided through a business appraiser's third-party objectivity. The goal of the valuator is to provide you with an independent, credible valuation without personal issues influencing the analysis.

In next month's *Think Tank*, I'll discuss some of the different approaches and methods used in valuing a business as well as how business valuation reports often come under legal scrutiny and what you can do to help support the value stated in those reports. Being informed about the need, use and process of business valuations, you gain a better chance of keeping the pot of gold at then end of your music retailing rainbow.

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