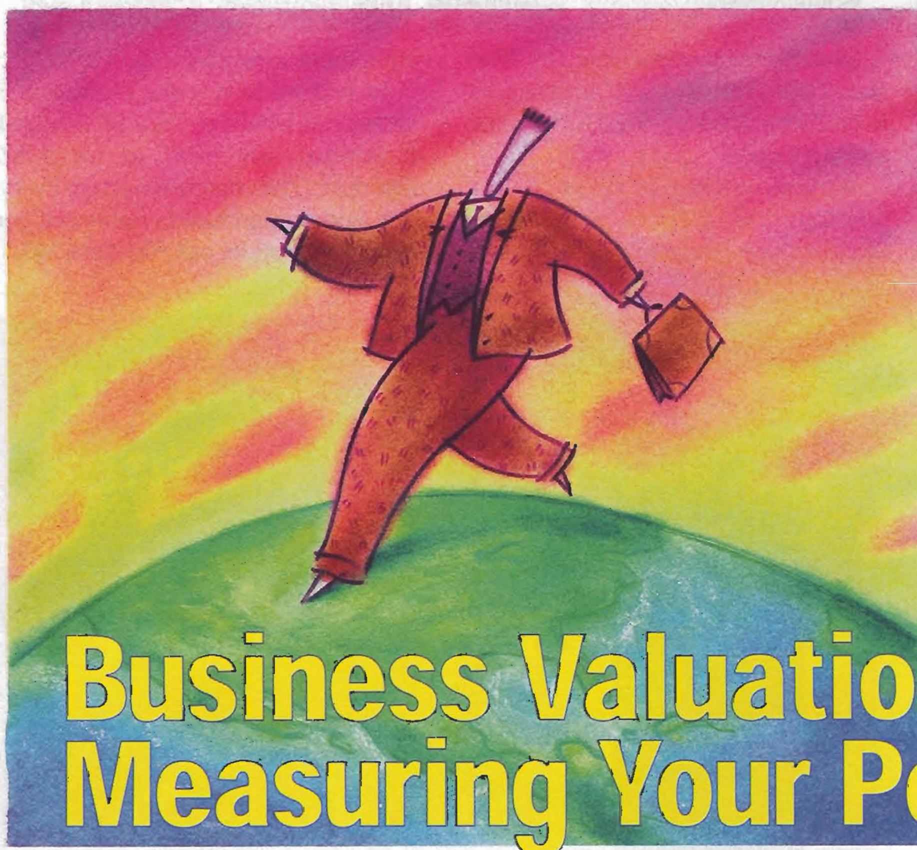

Business Valuations: Measuring Your Pot of Gold

As we discussed in last month's *Think Tank*, there are several different reasons for valuing a business. Unfortunately, answering the question, "How much is my business worth?" is anything but simple.

And the issue becomes more complicated since each business is different and every owner has a different purpose, motive and/or goal for the valuation of their business. This article will try to simplify the "when to" and "how to" of business valuations.

Last month, we spoke briefly about the plight of music retailer Shecky Schnitzle, owner of Shecky's House of Rock and Schlock. To recap, Shecky's been in the music retailing business for 40 years, but now wants to get out. He's 67 years old, tired of the retail grind and fed up with competing against big-box and internet retailers. Shecky's employees are disgruntled because they've seen little increase in compensation and opportunity for advancement. And to complicate matters, Shecky's wife has filed for divorce, leaving Shecky very upset.

One of Shecky's competitors has made him an offer of $500,000 for the business. He wants to sell the business to his employees for $1 million. At the same time, Shecky has told his wife's divorce attorney that the business is worth nothing, while her attorney believes it is worth $2 million.

So we have a range in business value of $0 to $2,000,000. What now?

The "Why" of Business Valuations

Business valuations are performed for a variety of reasons, which we can put into four categories: tax, buy/sell, litigation and management purposes. It's important to consider the purpose why a valuation is needed, as different purposes may require the use of different methods, potentially resulting in different values. For example, a valuation for tax purposes will rely more on the company's historical records than will a valuation for the sale of a business, which relies more on projections. Here's some common reasons for a business valuation.

Tax Purposes

Gift and Tax Issues. Gift and estate tax issues continue to become more complex. As business owners attain greater wealth, business succession and inheritance invariably cause large tax liabilities. A credible valuation can minimize estate and gift taxes and reduce the potential for IRS audits or other legal disputes.

Allocation of Acquisition Price. Our tax law can provide tax benefits through the proper allocation of the purchase price to personal, real and intangible property upon the purchase of business assets. A business valuation can assist in achieving these tax benefits.

Buy/Sell Purposes

Business Acquisitions and Sales. The purchase or sale of a business is one of the leading reasons for conducting a valuation. Without a proper valuation, a buyer may pay too much for a business, potentially eroding their chance for financial success. Likewise, a seller may receive too little for the business, causing the loss of substantial dollars for unpaid goodwill and other intangible values.

Buy/Sell Agreements. The smart thing to do when entering into a business relationship is to establish a for-

mal agreement for ending that business relationship. Buy-sell agreements, supported by clear definitions of market value, can eliminate difficulties associated with transferring the business upon the death or disability of an owner-partner.

Litigation Support Purposes

Divorce. Marital dissolutions are another major reason for business valuations. Determining an accurate assessment of value may minimize the need for litigation. If litigation is required, a variety of valuation issues must be considered, including goodwill, reasonable owner's salary and the lack of marketability to sell the business.

Bankruptcy and Reorganization. When considering bankruptcy or reorganization, the primary question is whether the company is worth more as a going concern than its liquidation value. Analyzing the business in a variety of operating scenarios will assist in structuring the most appropriate reorganization or liquidation plan.

Management Assistance Purposes

Financing. Valuation needs frequently arise when attempting to secure bank financing, as business valuations include a determination of the value of both tangible and intangible assets.

Business Plans. Business valuators can be helpful in reviewing and assessing the business plans of companies that offer an investment or partnership opportunity. This allows prospective investors further insight into the risk and value of the investment opportunity.

Shecky's Choice

As you can see, our buddy Shecky needs a business valuation for four different reasons: a potential sale of his business to a competitor, a potential transfer of his business to his employees, a potential refinancing of his business to keep it going under his continued ownership and control and a potential liquidation of his business to pay off his "lousy ex-wife and her S.O.B. attorney" (Shecky's quote, not mine).

As we've mentioned, it is possible to have four different values based on differing premises of value. But this would require separate valuation engagements for each premise of value—a potentially costly endeavor.

Shecky sought the advice of a business valuator and was given three types of valuation engagements to choose from: (a) a full-blown, comprehensive 50-page report at a cost of $10,000, (b) a limited-scope valuation at a cost of $2,500 or (c) a cursory valuation report for $399 (through NAMM's affiliation with Industry Insights). Knowing the report would come under divorce court scrutiny, Shecky engaged the valuation expert to do a full-blown, comprehensive valuation of his music retailing business under the fair market value premise.

Baby, You Can Drive My Business

There's a common term used by business valuation experts called "value drivers." (First time I heard that I thought they were referring to discounted golf clubs, but I found out later that this term actually refers to the key elements that determine the value of a business.) Some of those drivers are: business size (yes, size does matter); past sales and earnings; customer base; employee base; years in business; market and industry environment; local, regional economic outlook; stability of past earnings; quality of management; product lines carried; competitive position; liquidity; and ease of entry into the industry. By identifying the key value drivers of a particular business, the appropriate valuation concept and method(s) can be determined.

A Method to This Madness

Although numerous methodologies exist in the valuation business, there are only three basic concepts to value. In simple terms, these concepts and methods are the pencil pushing, spreadsheet-rattling calculation exercises that are used to arrive at a proper valuation. They are as follows:

The Income Concept. This incorporates various income-oriented methods such as the capitalization of earnings method and the discounted cash flows method. These methods are best suited for companies whose "earnings" are considered the best measurement of an investor's return. The income concept is most suitable when a company's business operations are able to provide a reasonable rate of return to its owners.

The Market Concept. This attempts to compare the financial condition and performance of the business being valued (also called the "subject company") to publicly traded companies (also called "guideline companies"). The guideline companies should have a similar financial makeup as the subject company. The market concept approach to valuation is most suitable when "earnings" are considered to be a good measure of the investor's expected future return and sufficient comparative company data is available.

The Asset/Cost Concept. This assumes that the economic value of a business comes from its productive assets less its liabilities. The "Adjusted Net Book Value Method" is a method used to value a business under this concept. It is based on the difference between the "fair market value" of the assets and the liabilities of the business. This concept is most suitable when the business has no investment value beyond the owner's reasonable compensation.

Valuations in Music Retailing

OK, so how does this ridiculously complicated stuff relate to determin-

ing the value of a typical music retailer? Hmmm. Good question.

It's pretty much a given that most music store owners get into the music retailing business for two reasons: they're passionate about music and they're looking for a decent job and wage. So let's face the hard truth. If an investor is going to put their money into a business, and expect a return commensurate with their risk, they generally wouldn't invest in a music store!

Although we find that many music retail businesses can provide a reasonable wage for their owners, the income stream does not usually produce a sufficient return of investment to justify the use of methods under "The Income Concept." Also, the determination of fair market value of a closely-held music retail business presents a problem because of the lack of a ready market and publicly traded music stores. For these reasons and others, it is often difficult or inappropriate to use the "Market Concept" to value a music store business. In many instances, we find the "Adjusted Net Book Value Method" under "Asset/Cost Concept" of valuation can often yield an appropriate value. Although it does not consider the earning capacity of a company, it does reflect the value of music store assets at adjusted amounts. These adjustments could include the downward adjustment for overstocked inventory or the upward adjustment for future contracted instrument rental income and other intangible assets.

To further complicate matters, there are still other methods that actually combine income- and asset-based approaches. These methods value a business based on the sum of adjusted net assets plus the value of the intangible assets. This highly subjective valuation is done by capitalizing the earnings that exceed a "reasonable" return on the net assets. If you don't understand what I just wrote, don't worry, I don't either. Suffice it to say, business valuations are complicated and subjective, but undeniably critical to the positive outcome of some precarious and troubling predicaments.

The Uncomfortable Scrutiny

It's important to remember that many business valuations are often challenged in a court of law. Accordingly, prosecution and defense teams will engage business valuation experts to testify. Each expert witness will attempt to demonstrate their business valuation expertise, credibility and knowledge of the business in question. During the court proceedings, the expert undergoes intense cross-examination by the opposing attorney who works to discredit the expert's testimony, and as a result, challenge the value of the opposing attorney's own expert.

Accordingly, it's imperative to use a business valuation expert with comprehensive (and maybe even music retailing) knowledge and skills in business valuation and litigation support. Their report must reflect their knowledge and expertise, and take into consideration all factors key to a correct value of the subject business. Clearly, a simple or brief report will undoubtedly get challenged, or thrown out of tax, divorce or civil court as inadequate.

Where's Shecky?

Based upon a reliable business valuation, Shecky came to his senses, dumped his girlfriend, bought his wife a 5-carat diamond ring, sold his business to a local competitor for $800,000, retired and moved to Florida with his wife. In the end, Shecky got to keep his pot of gold—in a bank account under his wife's name. Way to go, Shecky!

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