Business Valuation Made Simple

It's all about ca$h.

BY DAVID S. HARRISON, CMA, CPA

I get a call late one night. "Harry, I got a job for ya. Just a quick thing—you ought to be able to knock it off in a day or two…" The caller—oh yeah, he's my client—wants me to put a price on an acquisition he's looking at. Turns out he's got a couple of businesses to look at.

Well, okay, my client didn't really call me late at night, and he doesn't call me Harry. But the rest—the part about a quick job that should only take a day or two—that's true enough. And my approach can even accommodate a visit or two from Mr. Murphy. Granted, my business valuation methods aren't groundbreaking: same old familiar discounted cash flow (DCF) analysis. It works reasonably well for nonpublic, small to mid-sized companies worth in the $1 million to $100 million range. So why pass on my experiences and my approach? The answer is in its simplicity. At times the simple and straightforward are overlooked, so perhaps the following might be helpful to some of you out there.

IT'S A SWEET SOLUTION.

The simplicity of a DCF valuation is probably what contributes most to underestimating the time required for valuation jobs in the first place. Think about it—it isn't the DCF calculations that require any time; they run in an instant. But the DCF is only as good as its inputs, so that old adage, "you are what you eat," couldn't be truer with respect to DCF. Good estimates yield good valuations; bad estimates…well, you know the rest. How do we get a reasonable range of estimates for our discounted cash flow? Therein lies the problem—the gremlin that eats away our time, drives us crazy, and makes us feel like plodding amateurs.

DCF: WHAT'S SO SPECIAL ABOUT IT?

Let's say you're my client and you've asked me for a valuation. I tell you I'm going to use cash flows for that. What? You say that runs counter to all those accounting principles I've been busy promulgating. And what about the virtues of matching revenues and expenses, accrual-based income, and its clear superiority over cash-based measures? Bang! Now that it matters, I bring you right back to cash. Meanwhile, I'm busy dancing around my seemingly schizophrenic approach to management accounting.

I admit that falling back on cash does seem awkward and inconsistent. Yes, there are better ways to value a business. Unfortunately, they either don't apply or haven't been discovered, so if cash works, why fight it? But first let's take a look at some valuation alternatives:

- The best method: Pay market.
- No market? Get a market appraisal.
- No market appraisal? Value the assets and liabilities. *Hey, isn't that what certified financials are?*
- CPA's financials no good? *Okay, now we're back to that cash-based solution.*

MARKET PRICE?

Simple—there's no market. If there were, then you wouldn't need an independent valuation, and if there *is* a market, who would pay more than market? And who would accept less? Get the picture?

GET AN APPRAISAL?

A market appraisal would be excellent, but chances are it's not so easy. No problem if you want to sell your house because a knowledgeable appraiser can take a quick look at any house and come up with a fast, accurate valuation. There's even a name for this quickie appraisal. It's called a drive-by, and you don't need to be a linguist to understand the derivation.

But will a business appraisal accurately reflect the true market price as with real estate? Probably not. Unlike housing markets with their "picture perfect" enactment of Econ 101's supply and demand relationships, businesses often just don't have sufficient numbers to support all those pretty Econ 101 curves. Think about it. Say you manufacture metal stampings. Sure you have competition, but you're for sale, not the competition. That gives you a supply curve made of, well, you. And what about those eager participants on the demand side? Maybe after searching around a bit you can find someone. The key word here is someone. The truth is that finding a fair price by searching out the supply and demand curves just won't happen.

VALUE THE PIECES?

If you can't value or appraise the whole business, perhaps valuing some of the pieces and then estimating the remainder would yield reasonable results. Surely some of the business assets (and certainly the liabilities) have pretty firm values. But business is more than a simple collection of assets. It's a carefully constructed combination of specific assets that, together with human and other less tangible elements, results in value more than the simple summation of its parts. The "sum is greater than the parts" phenomenon is simply the nature of business, so this approach possibly leaves you with a major valuation component unaddressed.

CERTIFIED FINANCIAL STATEMENTS = NET WORTH?

Sure it does. But you can't take "certified" net worth to the bank. Well, actually, I guess you can. Bankers are always asking for certified statements, aren't they? Isn't net worth a pretty good synonym for valuation since it's supposed to be the value of the business after all outside claims are taken away? CPAs certify that the financials, including the net worth, are presented fairly. But, wait, this very carefully chosen CPA language doesn't really say anything about the value of a company, does it? I don't think so.

Remember those bankers (and investors)? Well, they're experts in the valuation business, and they invented a term just to make sure that they would never inadvertently equate the CPA's "net worth" figure with market value. They refer to the CPA's net worth figure as book value, the implication being just that. Book value is what the books say it is—nothing more, nothing less. It isn't market value. CPAs agree and will be the first to tell you that the "certified" net worth figures are consistent, comparable, and accurate numbers, but they often have little to do with true market valuation.

BACK TO THE BASICS: CASH!

Let's use the "D" words—divorce and death—to show just why cash is king. Both are situations often requiring valuations but really just looking for cash.

With the first D, divorce, one spouse wants to be compensated (that means cash) for their "share" of the business—and compensated well, you can be sure. Meanwhile, the other marriage "partner" just wants the business to keep on trucking as it had been. Enter the process of business valuation and, with it, often intense (and sometimes ugly) issues. Death and valuing estates that include ongoing businesses similarly give rise to what we might kindly call the squabblings of "friendly" heirs. It's the same deal.

What is it that the "D" partner and heirs really want? Simple, they want cash. End of story! If cash is what the marriage partner, the heirs, and our friendly IRS governmental partner want, then lay it out like this: If the divorcé got a cash settlement today, let's say he would put the money to work in the market or bank or whatever, expecting a reasonable return over time. If that's a valid assumption, you can then arguably equate the expected future returns of the invested settlement to the cash that the business would generate over time. Simple DCF. The trick is to come up with reasonable estimates for future business cash flows. Do that, equate it with the value of today's "cash in the bank," and you have the exact value of that particular business, no more, no less. A perfect valuation every time.

This is the cash-simulation method of business valuation. If we know the expected future cash returns from the company (without selling it), then just work backwards, and you get today's "simulated bank balance." This "pretend" cash in the bank is the valuation. Put another way, it's that amount of cash in the bank that has the same cash-generating power as the business. If you can reasonably estimate the cash-generating power of a business, you know its cash value. The formula is simple, it works, and it even retains a bit of mystery end-around stuff that makes it a little fun and showy. It's a sweet solution. And you can avoid all the intangibles and messy goodwill issues.

Now we're back to that "you are what you eat" deal—namely that getting reliable future cash flow estimates for the business can get a little dicey, but we have to earn those hefty consulting fees somehow, so here's how we earn our paycheck.

First, I said before to forget about GAAP and certified financials. Well, not completely. Go to that third financial statement, the cash flow. It's a report of prior cash flows, and we want the future, but remember what our history teacher said about the past—that history repeats itself? If so, the past—prior cash flows—is a decent starting point. We know (unfortunately all too well in these days of Enron and others) that we can't trust the statements too much. But unlike some items that can be clouded with financial reporting issues, cash is real, finite, and measurable. Cash is cash. Also available are tax returns, which often come in the cash-based flavor we are looking for. Thanks, IRS.

BUSINESS VALUATION: HOW TO DO IT

I just showed you that reasonable future cash flow estimates yield good valuations. Borrowing from History 101, we can use a combination of prior cash flow statements, tax returns, and some of our own adjustments, add a little of our own business and economic assumptions, and we've got those predicted future cash flows. The valuation is subject to some variation based on our predictive abilities, assumptions, and all that, but within reasonable limits it is fair, objective, and, best of all, something those "D" people can literally take to the bank with them.

Let's look at the steps.

STEP 1: Adjust Prior Period Cash Flows

◆ Financials (certified preferred) should be accurate reflections of the previous cash flows. Have some healthy skepticism (reconcile to bank statements, talk to the auditors), but unless cash is finding another mysterious home somewhere, the good news is that cash is cash and not subject to some of the "issues" that tend to move earnings around. You can also use tax returns, but keep in mind the "ends" to which tax returns are sometimes stretched.

◆ Next, normal "owner or executive" adjustments are necessary. This can be a touchy area. Privately owned businesses often include expenses that would change under different, not-so-private ownership. Included would be personal expenses such as cars, club memberships, travel and entertainment expenses, and payroll. For example, the existing owners may like Jaguars, golf, and traveling liberally. Correspondingly, owners, spouses, nephews, and others may wind up on the payroll doing minimal work and at inflated salaries. (I never said that…)

◆ Going the other way, some owners may run the business much "tighter" than normal. This contributes to inflated cash flows. For example, owners may take little or no salary, although they contribute strongly to the success of the business, or they could control spending and expenses to a level that would not be possible "normally."

◆ These "de-personalizing" adjustments require judgment and will never be estimated perfectly, but reasonable estimates aren't too difficult, are usually adequate, and can precipitate some interesting discussions toward further pertinent information.

STEP 2: Project Future Cash Flows

◆ Use the historical, adjusted cash flows (step 1) to estimate future cash flows. A range of high, mid, and low cash flow estimates is often helpful. Economic factors such as industry trends and economic conditions should be researched and included in determining the range of growth estimates for sales and expenses.

◆ Effects from a change in ownership should be considered. A sales drop from loss of special customer relationships with prior owners or possible favorable influences from synergies with the new owners should be researched. Be careful here. The sales drop is part of the existing business's valuation; new synergies or planned new investment (productivity improvement) is not. Yet new owners may want these synergy or productivity effects done as relevant "side calculations."

STEP 3: Determine Discount Rates and Projection Periods

◆ Cash generated six years from now has less "present value" worth than cash today. Depending on current economic indicators, rates from 5% to 25% may be appropriate. The rate used has a tremendous influence on the ultimate valuation amount, so use what's common for the industry. Know your valuation customer as well. If this is one of the "D" negotiations, consider the rate the interested party would expect in market returns.

◆ Level of risk in the venture's ability to meet projected cash returns should be factored into the return rate. A riskier business, just as in the stock market, should generate a higher return and be valued with a higher discount rate. Some academics and others argue that risk adjustment is duplicative because it's already in the return. I don't know; I'd factor it in.

◆ Predictability issues: Next year's projection may be fairly predictable, but how about the projection for year five? How stable is the industry? Is this a high-tech industry that may be outmoded within a few years? These judgments will affect both the discount rate and the number of periods used for future projections.

◆ The cash value of assets at the end of the projection period (usually five to 10 years is appropriate) needs to be roughly estimated. Rough estimates are okay here as the discount rate will deflate them substantially. Some allowance should be made for a "pretend" business dissolution at the end of the projection period. For some assets, such as land or buildings, appreciation may realistically be assumed.

STEP 4: Put It All Together

◆ Now comes the easy—and the hard—part. *Easy part*: Run the valuation program. Most spreadsheets have these functions. You're looking for the net present value or discounted cash flow function, which results in your "answer," your valuation. Do it for several scenarios: high, medium, and low expectations.

◆ *Hard part*: Sit back, look at the valuation estimates, and judge whether they are meaningful reflections of current valuation. Don't let the mechanics of the numbers take on a meaning of their own. Talk to industry analysts, competitors, and customers. Since the numbers don't tell it all, the subjective analysis of the objective numbers is critical.

◆ *Personal taxes*: This isn't part of the valuation but may be very relevant for some buyers or sellers. As always, have a tax accountant spell out these individualized effects.

ARE WE DONE?

As for me, things worked out pretty well this time around. That client of mine looked at four businesses and bought two of them. I traveled around a day or so for each, and it took me a couple of days to translate everything into reasonable valuations. The valuation is history, the numbers are good, everybody's happy. My client has changed, though. Now he really does call me late at night—calls me Harry. ■

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