

Understanding and Utilizing Your Client's Estimates of Value

The following paper, Understanding and Utilizing Your Client's Estimates of Value, was prepared by Ryan Thompson, CPA, CVA, Valuation Analyst at BizEquity. It is shared with permission from the author and BizEquity.



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Your Valuation

Equity Value (Latest Valuation)

\$617,523

Beta International

This fair market value conclusion is the value of the company available to its owners or shareholders and incorporates all of the assets included in the "asset value" plus the firm's liquid financial assets (cash, A/R, deposits, etc.) and minus its liabilities (ST and LT).

Valuation History (Past 12 Months)

Valuation History

DATE	VALUATION
12/31/2018	\$617,523
9/30/2018	\$580,000
6/30/2018	\$550,000
3/31/2018	\$520,000
12/31/2017	\$500,000
9/30/2017	\$480,000
6/30/2017	\$460,000
3/31/2017	\$440,000
12/31/2016	\$420,000
9/30/2016	\$400,000
6/30/2016	\$380,000
3/31/2016	\$360,000
12/31/2015	\$340,000
9/30/2015	\$320,000
6/30/2015	\$300,000
3/31/2015	\$280,000
12/31/2014	\$260,000
9/30/2014	\$240,000
6/30/2014	\$220,000
3/31/2014	\$200,000
12/31/2013	\$180,000
9/30/2013	\$160,000
6/30/2013	\$140,000
3/31/2013	\$120,000
12/31/2012	\$100,000
9/30/2012	\$80,000
6/30/2012	\$60,000
3/31/2012	\$40,000
12/31/2011	\$20,000

Understanding and Utilizing **YOUR CLIENT'S ESTIMATES OF VALUE**

Prepared by

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Understanding and Utilizing Your Client's Estimates of Value

The BizEquity report produces four estimates of potential value for a business:

- **Asset Sale Value**
- **Equity Value**
- **Enterprise Value**
- **Liquidation Value**

A common question asked by users of the tool (and of valuation in general), is which type of value is most meaningful. The most appropriate answer to this question is also one that causes the most eye rolls: “it depends”. Readers can rejoice however, as we will provide a deeper explanation of the types of values, as well as situations in which some values are more pertinent than others.

When performing a business valuation, a valuator can arrive at different types of value depending on the circumstances of the valuation. For many this is difficult to understand, as they rightfully challenge “How can the same business be worth different amounts?” In the end the business is ultimately worth one value, but the way that value is portrayed can depend on the lenses through which we view it and the components that are included in any final sale price.

For starters, it is important to note that the BizEquity report produces a probable fair market value of 100% controlling interest of the subject company. This is important to understand as other standards of value (i.e. fair value, investment/strategic value, etc.) and levels of value (i.e. minority non-controlling interest) can also impact the final value. It is possible that a buyer may be willing to pay more for a business than a hypothetical buyer, as they can gain additional values through synergies or other circumstances (strategic versus fair market value). Additionally, a buyer may not be willing to pay a premium for the firm if they are not going to get a controlling interest in the firm (controlling versus minority interest). Discounts and /or premiums can be applied to the company's value to account for these potential scenarios but are beyond the scope of this article (see article *Multiples, Cap Rates, and Discounts* for more information on this).

The BizEquity tool produces four estimates of value for the probable fair market value of a 100% controlling interest in the subject company. To begin, we will define each of these types of value and the calculations used in developing the estimates. The difference between an asset sale versus a stock sale is also discussed, as it may allow for enhanced conversations with clients regarding the value of their business and the terms of future potential transactions.

Understanding and Utilizing Your Client's Estimates of Value

Asset Sale Value

Generally, this value includes ONLY inventory/supplies, fixed assets, and all intangible assets. Excludes all liquid financial assets and all liabilities. A buyer operates from newly formed legal entity. The intangible assets include those that may not be reflected directly on a client balance sheet such as goodwill, trade name, brand, customer list, etc.

Most small business transactions are completed as “asset sales” (more on that later), meaning that the incoming buyer is purchasing the tangible and intangible assets of the company, but is not usually inheriting the actual entity and its liabilities. In an asset sale, the buyer will set up its own new legal entity and move the purchased assets into it. Furthermore, in an asset sale, the seller will typically keep their cash, accounts receivable (AR) and other liquid financial assets but will also be responsible for settling any debts/liabilities of the company; as such, these items (cash, AR, liquid assets, and liabilities) are not included in the “asset sale value”.

Calculating Asset Sale Value

Value of Inventory
+ Value of Furniture, Fixtures & Equipment
+ Value of Intangibles

Asset Sale Value

A user may likely find that if they go to their client's balance sheet and add up the items listed above, it is vastly different than the Asset Sale Value generated by BizEquity's Software. This difference is largely due to the fact that a company's full intangible value (i.e. goodwill, customer list, trade name, brand, etc.) is rarely captured on their balance sheet. ***Most businesses will be worth more than the value of their individual assets due to the fact the assets collectively have the ability to generate profits.***

Let's consider an accounting firm. It is likely that a small accounting shop will have some tables, chairs, desks, and computers, but will not have any machinery or inventory. It follows that the actual tangible assets of the firm would have very little value. So how is it that a firm with just some tables and chairs can be worth hundreds of thousands of dollars? It is because there is something (something intangible) that is creating value. Sure, an incoming buyer is purchasing the business's tables and chairs, but they are also purchasing something that has a reliable and recurring customer base, a set of business processes that allow the firm to run smoothly, a trained and assembled workforce, a reputable business name, etc. Each of these can be considered intangible and would be included within the calculation of the Asset Sale Value (to the extent they exist).

It will also be helpful for readers to understand when the Asset Sale Value is primarily utilized. This value will generally be used when buying or selling a business (assuming it is a typical asset sale). The Asset Sale Value is also meaningful in assisting a current owner in tracking the changes in the business value over time.

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Equity Value

Equity Value Includes the assets listed above PLUS liquid financial assets LESS all liabilities (ST/LT). It can be defined as the value of a company available to owners or shareholders.

Calculating Equity Value

Asset Sale Value
+ Cash
+ Accounts Receivables
+ Liquid Financial Assets
- Long-Term Liabilities
- Short-Term Liabilities

Equity Value

In general, the Equity Value has slightly more potential use cases than the so called "Asset Sale Value", in that it is used during a "Stock Sale", it is the primary value for gift/estate purposes, it is the base for buy/sell agreements amongst shareholders and is also utilized in marital litigation or divorce cases¹. Another interesting way to think of Equity Value is that, even during an asset sale, it represents the value of the business that will go to the shareholders after the liabilities have been paid.

Example #1: A business owner sells their business in a stock sale. As such, the incoming buyer is purchasing equity of the current company which includes obtaining control of the assets (both tangible and intangible) but will also be inheriting the company's current payables, loans and other liabilities. Essentially the name on the office nameplate is changing, but everything else within the business will remain the same.

Example #2: A business owner lists their business for sale but wants to sell it as an asset sale. In this way, the incoming buyer will purchase the assets (both tangible and intangible) but will not inherit any of the current liabilities. The incoming buyer will also not be obtaining the current company entity and will instead be setting up their own entity with its individual tax identification number. Continuing with this example, assume the Asset Sale Value is \$1,000,000 with the business having \$100,000 in cash, \$100,000 in accounts receivable and \$300,000 in debt. Mechanically, the incoming buyer will pay the seller \$1m and the seller will also get to keep their cash and AR. The owner now has a total of \$1.2m at their disposal; however, they need to settle their outstanding liabilities. After paying off these debts, the owner now has \$900,000. The business sold for \$1m (the asset sale value) and the owner ended up with \$900,000 (the equity value). In this way, the relationship between the asset sale value and the equity value is clear.

¹It should be noted that while credible, with the appropriate entry and accuracy of the underlying information input by the user, the values generated by the software are not intended to be directly utilized in IRS/DOL/litigation matters as these will usually mandate reliance on a professional appraiser; however, the tool could be useful in planning for these scenarios.

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Enterprise Value

The Enterprise Value (“EV”) is a comprehensive measure of the value of a company’s core business operations to ALL investors in the company. This includes equity owners (stock ownership) as well as creditors (debt holders). Said another way, EV is a measure of the value of a company’s business operations, without regard to its capital structure, which can be helpful in that it facilitates the comparison of companies with varying levels of debt. Enterprise Value can be thought of as equity value, plus debt and less cash.

Calculating Enterprise Value:

+ Equity Value
+ Long-Term Interest-Bearing Debt
– Cash

Enterprise Value

When the term “equity” value is utilized, it is usually referring to the value to the shareholders. Enterprise Value goes a step further and considers the value of the company to creditors as well to provide a more complete view of a company’s value.

The term is often used by investment bankers and others in the M&A space as it can be thought of as a theoretical takeover cost of a company. While generally utilized more often in middle market transactions, Enterprise Value is still applicable to all businesses as it represents the total value of the company as an operating entity. One reason that it is utilized less often for smaller businesses is that it includes the impact from items such as accounts receivable and short-term payables, which are generally not included within the Asset Sale Value. As middle market transactions deal with larger companies and ultimately more complex operations than that of a smaller business, Enterprise Value is considered in lieu of the Asset Sale Value in that it could include the buyer inheriting some of the business’s current assets and liabilities.

Additional Thoughts on Asset, Equity and Enterprise Value

It is easy to see that the Enterprise Value and the Asset Sale Value are closely related. In actuality, the Enterprise, Equity and Asset Sale Values are all very similar, with just mathematical differences on what assets and liabilities are being included or excluded.

One item that should be clarified is that none of these values are absolute in terms of what price should be paid for a business. While the Asset Sale Value will typically be utilized in smaller transactions, the actual deal terms of the transaction will dictate the final price. For instance, if a BizEquity report generates an Asset Sale Value of \$1m but the buyer/seller agree that they would like to include accounts receivable in the sale, then the AR would be added to the Asset Sale Value. It is important to understand what is already included or excluded from each valuation estimate so that any adjustments to the final price can be made appropriately.

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Liquidation Value

In terms of business valuation, we often consider that a business will be a “going concern” which is an accounting term meaning a company has the ability, capacity, and resources to continue operating indefinitely. Ultimately however, some businesses will fail or may decide to discontinue operations. Generally speaking, the Liquidation Value is the value of the firm's physical assets, if the business were to shut its doors, which can either be orderly or forced.

Orderly – This represents the Liquidation Value at which the asset or assets can be sold over a reasonable period of time to maximize the proceeds received. The business owner may be retiring with no intentional to sell and can take their time to sell their asset piecemeal at a reasonable price.

Forced – This represents the Liquidation Value at which the asset or assets can be sold as quickly as possible, such as at an auction.

The Liquidation Value produced by BizEquity's software more closely represents a “forced” liquidation value. As this is the value of the company during a “fire sale” it is typically not frequently utilized but can be considered to represent a “floor” value of the business. In effect, it represents selling your business's assets for pennies on the dollar.

Calculating Liquidation Value:

$$\begin{array}{r} \text{Fair Market Value of Identifiable Tangible} \\ \text{Assets} - \text{Long- and Short-Term Liabilities} \\ \hline \textit{Liquidation Value} \end{array}$$

As detailed above, the Liquidation Value produced by the software entails the business' tangible assets selling for a reduced price (in order to unload them quickly) and also the owner being responsible for the remaining business liabilities (loans, payables, etc.). *It is not unusual to see the Liquidation Value as a negative number as selling the assets at a reduced price may not be sufficient enough to cover the business liabilities.* A negative value can be expressed as the theoretical amount of remaining liabilities that the owner would be personally responsible for fulfilling after liquidating all of the business assets.

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Asset Sales Versus Stock Sale

As discussed earlier in this whitepaper, an asset sale typically involves a sale of individual assets and liabilities, while a stock sale represents the purchase of the current owner's shares in the company. While attorneys, accountants and other consultants will and should assist in any formal transactions, the ability to recognize the nuances of an asset sale versus a stock sale is paramount to understanding your BizEquity report and demonstrating additional value to your clients.

Asset Sale

Under an asset sale, the buyer is purchasing only the company's assets and is not usually responsible for any of the liabilities of the previous management. The buyer will set up a new type of entity in this type of sale. Generally, *a buyer will also prefer an asset sale due to their ability to gain a step up in basis on the acquired assets*, which will allow the buyer greater depreciation and subsequently lower potential taxes in the earlier years of new ownership.

Seller's would typically prefer an equity sale, because under an asset sale they tend to generate higher taxes for the seller. The portion of the sale allocated toward goodwill is taxed at capital gains tax rates while the sale other hard assets is taxed at ordinary income tax rates which are typically higher than the capital gains rates.

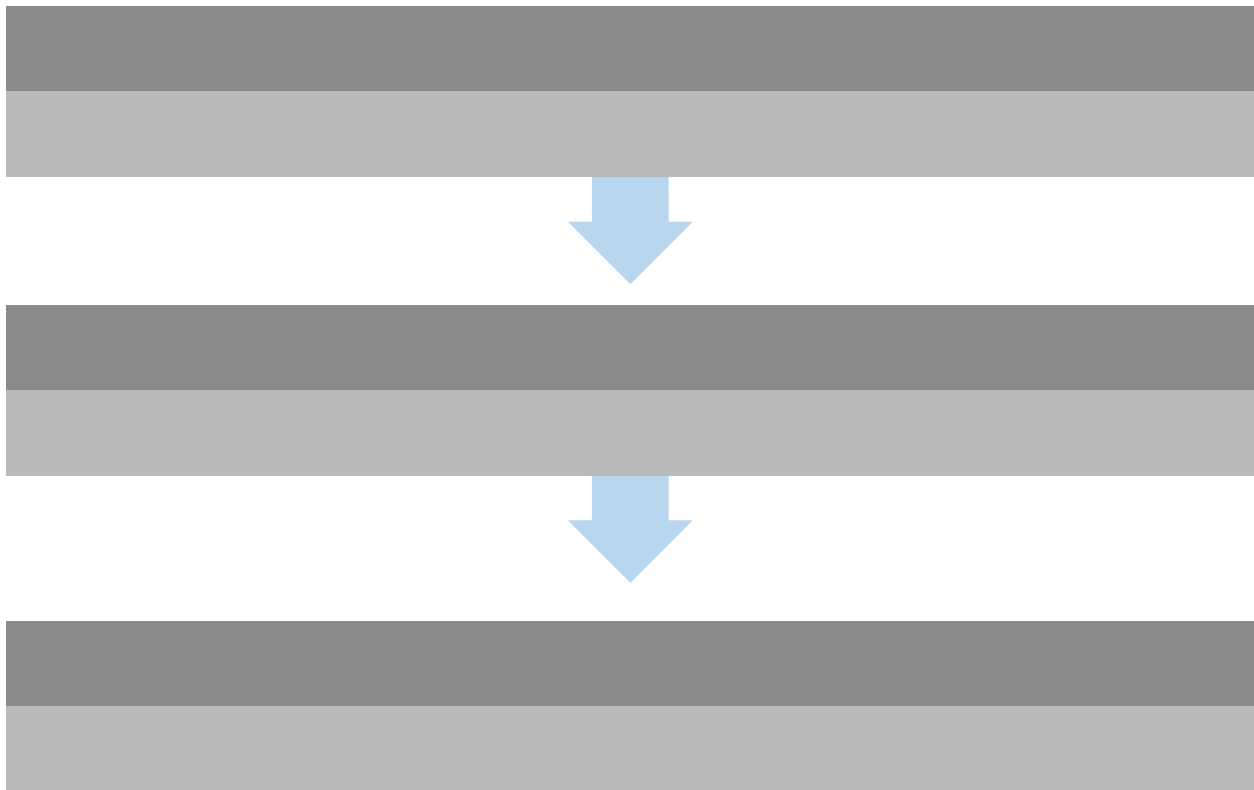
Stock Sale

Under a stock sale a buyer does not have the ability to step up their basis, so it is less preferable from a tax standpoint. The current basis of the assets will simply transfer to the buyer, resulting in the potential for less depreciation, higher income and thus higher potential taxes being paid in the earlier years of new ownership. However, *a buyer may prefer to structure the deal as a stock sale if the business has favorable contracts that may be difficult to assign, favorable relationships with large vendors/customers or has a considerable number of patents/copyrights.*

Typically, *a seller would prefer a stock sale as proceeds are taxed at lower capital gains rates representing a more favorable tax situation.* Depending on how the transaction is ultimately structured, the seller may also have limited responsibility for company liabilities related to product liability, employee lawsuits, pensions, contract claims, etc.

ASSET SALE	STOCK SALE
Only Inventory, Fixed Assets and Intangible Assets	All Assets (on and off-balance sheet)
Asset Sale Value will generally be utilized	Equity Sale Value will generally be utilized
No Liabilities	All liabilities (known and unknown)
Allocation of Purchase Price	No Allocation (buyer inherits all account balances as they are for both book and tax purposes)
Ability to "step up" the basis of fixed assets	Inability to "step up" basis of fixed assets (except via a Section 338 transaction)
Avoidance of unknown liabilities	Greater exposure to unknown liabilities (i.e. lawsuits, warranty, obligations, product return, etc)
Limited tax maneuvers	Creative deal structures available for tax purposes

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