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WHITE PAPER

Business Valuations – Which Method Will Most Accurately Predict Your Enterprise Value?

By Chuck Gottschalk

When I was a young accountant in my early 20s, I was blessed to be mentored by an amazing and successful businessman. He had spent a career buying and selling companies and by 1990 had amassed close to $100 million in wealth (and in 1990, $100 million was still a lot of money!). This mentoring lasted nearly 10 years, and he would constantly use the same phrases and stories over and over again to make certain I understood the importance of the life lessons he had learned in amassing his wealth. These phrases included, "one day we have chicken, and the next feathers" to describe volatility. Another was, "you've gotten your hand stuck in the lion's mouth, now the key is to get it out losing as few fingers as possible" to talk about mitigating losses.

But my favorite lesson came from the story of the man who calls the scrap dealer on the phone:

> Scrap Dealer – "Hello."
> Man – "Hello, how much are you paying for scrap?"
> Scrap Dealer – "$160 a ton."
> Man – "The newspaper says scrap is selling for $200 a ton."
> Scrap Dealer – "Then I suggest that you sell it to the newspaper."

Sometimes he would be more direct to outsiders when they would attempt to sell him something that had been appraised and he was offering less, and he would simply say, "Then I suggest you sell it to the appraiser." The point of all this is that I understood that ultimately *sales price is decided by what a willing buyer is willing to pay, and a willing seller is willing to accept.*

You may be at a point where you are interested in the estimated value of your company. Perhaps you have even thought of having a third-party value your company. If you hire an appraiser, they are likely to come highly credentialed and will give you a specific number as your value. At TobinLeff, we have been involved in over 150 transactions, and what we can tell you with certainty is that a business has never been sold for the exact amount that a third-party appraisal states as its value. Some appraisers have been close to determining the actual amount realized, but oftentimes they are materially higher or lower.

The International Glossary of Business Valuation Terms, which nearly all appraisals look to when preparing a valuation, defines fair market value as, "The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." Thus, it appears on the surface that appraisers are aiming to reach the same objective as my mentor taught me. Unfortunately, they miss with great frequency.

With this deviation between the appraised value and actual value in mind, how should you go about getting the estimate as to what your company is worth with a level of confidence that the appraisal will at least be close? Before we get to that answer, let's first talk about what exactly a business valuation is and the various valuation techniques used.

A business valuation is a process whereby the economic value, or before tax cash flow, a company would receive if it were sold at a point in time is projected. Under professional standards and practices, most techniques used by business appraisers can be classified into three broad conceptual approaches: Income Approach, Market Approach, and Cost/Asset Approach. Within each of these, there are commonly accepted methodologies for the practical determination of value.

Under the Income Approach, we most commonly see appraisers use the capitalization of earnings, also sometimes called discounted cash flow method, whereby the appraiser attempts to value future economic benefit streams (usually cash flow) in present value dollars at the date of valuation.

Under the Market Approach, we most commonly see appraisers utilize marketplace transactions and comparisons to companies that are sufficiently similar to the company being appraised to indicate value through the use of multiples. General valuation theory requires that appraisers must use the market approach when valuing shares of stock of closely held corporations. Unfortunately, this information is extremely difficult to obtain with accuracy for private sales. And, even if prices can be determined, unless you've been directly involved in the transaction, you don't know the terms of the deal which can cause enormous fluctuations in the actual value of any stated price.

To make matters more confusing, there are approximately 17 different commonly accepted methodologies that appraisers can choose from within the three broad conceptual approaches. And most appraisers don't simply take one of these methodologies when getting it wrong, but they take two or three and then use an average to determine their guess as to fair market value. Unfortunately, many of these techniques do not ensure accurate results. The Achilles Heel of many of the Market Approach methods is that reliable information on transactions of private companies is not available so the appraisers use comps of public companies where the multiples and ratios are not comparable.

However, in our experience at TobinLeff, we have found that there is a methodology that works.

For the many companies for which TobinLeff has represented either the buyer or the seller, the price has been based on a multiple of normalized EBITDA (earnings before interest, taxes depreciation & amortization). Normalized EBITDA is the calculation of the earnings that a buyer would expect to realize. We start with accrual basis book EBITDA and then make normalizing adjustments. An example of a normalizing expense would be a company for which the owner was paid no compensation and only received distributions. We would reduce the book EBITDA for the fair market value of the owner's salary to determine normalized EBITDA. There are many other items that result in normalization including owner discretionary expenditures, PPP/ERTC monies, and non-recurring expenses.

The balance sheet adjustment is determined by the difference between the amount of working capital on hand, and the amount that a buyer requires to be delivered to support the underlying normalized cash flow – called the working capital target. If the working capital is higher than target, then a distribution of the excess amount is made to the seller at the closing, and if it is less than the target, the seller's proceeds are reduced for the shortfall.

At TobinLeff we have prepared numerous "range of market value" analyses as the baseline for taking our clients to market when they are ready for a sale. We establish a floor below which we would not recommend that a client sell and estimate the above-market price that we will strive to achieve. To estimate the range of values, we look at "hard items", "soft items," and our "comps".

Hard items are concerned with the numbers and data found on financial statements like the balance sheet and income statement. This analysis, enhanced by the use of financial ratios such as client concentration and retention, revenue growth, and profitability, allows us to get a grasp on a company's financial position and make projections into the future. Hard items analysis is driven by mathematics and is the objective part of the process.

Soft items are the things that make a company unique, such as their value proposition, the quality of the management team, industry focus, reduced dependency on selling owners, corporate culture, and barriers to entry. Soft items analysis is the subjective part of the process that requires experience, expertise, and deep knowledge of the specific marketplace.

The final step is then to look at the hard items and the soft items in the context of the hundreds of comps that we have generated throughout our 13 years in business to develop our final "range of market value." Only at this point can we truly determine the appropriate range of multiples to apply against the normalized EBITDA. This range is based on what we know from experience that willing buyers will pay and willing sellers will accept. The non-publicly available information we have compiled over more than a decade in this business and industry combines with the passion and experience of our team to create TobinLeff's secret formula for success.

We have been told that some of our competitors offer a valuation through an algorithm. We find that the ability to accurately value a business through an algorithm simply defies logic and good business practice. Perhaps someday artificial intelligence will allow for such an approach; however, business valuation is at least as much art as it is science, and, as of today, human intervention is required to interpret the results. Before we provide a client with a "range of market value," we have had numerous calls and emails to truly understand their individual story. Simply put, an appraisal of a business is far more than a question of numbers; it is equally an appreciation of the qualitative (soft) items combined with practical industry knowledge.

If you are interested in a Market Value Analysis for your company, we are glad to assist. If you choose to use a third-party appraiser or an algorithm for a valuation, don't be surprised if prospective buyers end up saying to you: "Then I suggest that you sell it to the appraiser."

About TobinLeff, LLC

TobinLeff is an M&A advisory and exit planning consulting firm that helps business owners sell to strategic buyers and private equity groups. With over 13 years of service and more than 155 engagements successfully completed, the TobinLeff team of 10 M&A advisors and exit planning consultants is dedicated to the mission of helping owners maximize and monetize their life's work. Please visit our website at tobinleff.com for additional information and case studies.

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