TobinLeff
Building & Monetizing Business Value℠
WHITE PAPER

What's Your Business Really Worth?:
A Practical Approach to Understanding the Value of Your Agency

By Scott Leff

Several years ago, we had a client agency that was jointly owned by a husband and wife who were getting a divorce. As part of the settlement, it was necessary to ascribe a value to the business. So, they each hired a business valuation firm.

Both of the hired firms (TobinLeff did not do either valuation as we were working in another role) were certified, professional valuators with good reputations. They gathered their information, analyzed the financials, assessed the market, and came up with their valuations. One firm said the agency was worth $4 million; the other said it was worth… $0!

How can this be? How can the same agency have values that are so far apart when credentialed, professional valuators are doing the assessment? Quite simply, because valuation is at least as much art as science.

IT'S HARD TO PUT A PRICE ON AIR

Part of the reason for this is the fundamental make-up of marketing/advertising/PR/digital and related marcomms. Think about your company. What are your major assets?:

- You – and if you're selling, you probably don't want to stick around for too long
- Your people – more specifically, the brainpower of your people
- Your clients – will they or won't they stay with a new owner
- Your brand – which may or may not remain, depending upon the acquirer's brand strategy

While the rare agency may have some intellectual property or a tangible asset or two, most are not like a factory or a piece of real estate. There aren't hard, depreciable, market-valued and replacement-valued assets that make up much of the transaction. Basically, what you're selling is goodwill and the promise of future cash flow backed up by… goodwill.

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So, the core drivers of value assessment for a marcomm business are the return that its acquirer will ultimately achieve, the quality of its work product (in other words, its team), the quality of its book of business, and, most importantly, how sustainable all of these things are once you ride off into the sunset.

Given all of this uncertainty and the intangible make-up of agency businesses, is it possible to come up with any reasonable estimate of value at all? Well, yes and no.

IT'S ALL ABOUT YOU

Your business certainly has value to you. There's psychic value, emotional value, ego value, work enjoyment value (hopefully), and financial value (again, hopefully). Which means that the starting point for valuing the business from your perspective as a seller is: How much do you have to get from a sale to make it attractive to you to give up ownership of your business?

This first step is the reality check phase of valuation. Most people think the things they own are more valuable than the market thinks they are. For example, most people think their home is worth more than it really is. This is simple human nature. And business owners are no different. After years of sweat and worry and plain old hard work, it's perfectly natural to believe that your business is worth a small fortune. Unfortunately, that small fortune is frequently a much bigger fortune than a new owner is willing to part with to enjoy the fruits of your labor. This is why, just like with selling a house, it's important to get the perspective of an objective, outside advisor to assess what the true likely value range is for your agency in today's marketplace.

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So, step one is coming up with your own threshold price at which you'd be willing to sell. This is the internally focused part of the valuation process. Now it's time to look outward and figure out how a market value might be developed.

EXCEPT IT'S ALSO ABOUT THEM

There are two types of valuations: **formal** and **informal**.

A **formal valuation** is performed by a certified valuation analyst. These are professionals who have completed specialized training, passed rigorous exams, and who maintain their credentials subject to the rules and requirements of national certifying bodies. Their formal reports will be long, comprehensive, full of references to financial research, and rich (some might say eye-glazingly rich) with charts and analyses of financial performance, benchmarks, trends, ratios, statistics, and projections. They may or may not have deep experience with the marcomm industry, but they definitely will have experience with financial analysis and valuation methods.

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An **informal estimate of value** will be more concise, a bit less mathematically taxing, and, if the estimator is well chosen, come from a deep understanding of the marketplace for marcomm agencies. It will be built on a firm knowledge of agency performance metrics and best practices, as well as experience with deals in the agency market. The informal estimate will apply real-world, experience-driven earnings multiples and pricing schemes to arrive at a realistic sale price range. It should also include an assessment of Value Drivers – performance and practice criteria that are particular to the marcomm space and can enhance or detract from the offers that are likely to come.

CLICK HERE for TobinLeff White Paper on Value Drivers

How do you choose between a formal and informal valuation? It really is driven by purpose. If you're planning for an exit and trying to assess what path to follow and what your sale price range is likely to be, an informal estimate should give you the information you need. However, if you are obtaining a valuation under circumstances where future controversy could arise – for example, in the divorce case I cited above or to buy-out minority partners – then a certified valuation from a valuator who is qualified to testify in court may be your best bet.

And sometimes, it's a hybrid of the two. At TobinLeff, we perform a valuation for nearly every client with whom we work. For our exit planning, sell-side, and buy-side clients, an informal estimate is usually sufficient. For other clients involved in different types of transactions such as merging two agencies that need valuations to determine relative ownership stakes in the new entity, we might enlist our certified valuation partner to combine their valuation scholarship with our industry knowledge in order to arrive at a still uncertified, but more comprehensive approach to the value. And, when legal protection is necessary, we'll refer it out for full certification.

SO HOW DO I FIND OUT WHAT I'M WORTH?

Just as there are multiple types of valuations, there are also multiple valuation methodologies. Some of these include:

- Multiple of EBITDA
- Comparables
- Discounted Future Cash Flow or Capitalization of Historic Earnings

Multiple of EBITDA

The one that agency owners are most familiar with is the "Multiple of EBITDA" approach. With this method, we look at historical EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), make certain adjustments such as one-time, out of the ordinary expenses and normalization of owner's salary, and then apply a multiple to that number driven by agency size, type, location, and Value Drivers analysis. Depending upon all of these factors, multiples can range anywhere from a low of 2.5 or 3 times EBITDA to as high as 8 times, and typically are between 3x and 6x for small to mid-size independents.

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Knowing where you might fall on this range is critical, and this is why it's essential to work with an advisor who has the pulse of the market and can provide you with good guidance.

Comparables

"Comparables" is, theoretically, the simplest and most direct approach. Look at other agencies like yours, find out what they sold for, and then apply the same multiple to you. Theoretically. The problem is, this information doesn't exist. Most agency transactions are private and relatively small, and your two friends who have sold really don't give you a reliable sample. Sales data are not available. And even if they were, knowing the price doesn't tell you about underlying variables like performance, Value Drivers, etc. This is another case where having an advisor with first-hand experience will only benefit you.

Discounted Future Cash Flow

"Discounted Future Cash Flow" (DCF) or Capitalization of Historic Earnings is the most common financial method. DCF estimates the future stream of cash flow (typically three to five years into the future) and applies a discount rate (based on a "capitalization rate" or rate of return necessary to make it an attractive investment vs. other uses of the money) to arrive at a present value for that future income. This figure is combined with the present value of what the company may be worth at the end of the cash flow streaming period – which is also discounted to a present value – to arrive at the estimated total current company value. This approach enables a buyer to decide what rate of return they want to receive and then assess what price they can afford to pay for your agency to generate that return. Capitalization of Historic Earnings is essentially the same approach applied to actual past cash flow rather than speculations about the future. The choice of which to use is driven by judgment factors around the likelihood of future earnings remaining relatively stable versus the expectation of significant volatility.

So how do we know which of all of these methods to apply? Sometimes we'll look at multiple approaches and average or weight them. Part of the consideration is the type of buyer. A strategic buyer (another business that is acquiring you as part of their own growth strategy) is likely to be driven by the multiple of EBITDA whether historic or future-based; a financial buyer (someone looking at you more from an investment than an operational perspective) will pay more attention to the Discounted Future Cash Flow/Capitalization of Historic Earnings. For most independent agencies, the most likely buyer is the strategic buyer, and that's why the multiple of EBITDA approach is the most commonly used.

Also, keep in mind that with all of these valuation methods, the strength or weakness of your balance sheet may be an additional factor. Sometimes, negotiations include an expectation that the seller deliver a company with adequate working capital (Current Assets minus Current Liabilities). Also, with most transactions, the seller will be responsible for paying off any long-term debt.

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IF IT SEEMS TOO GOOD TO BE TRUE, IT PROBABLY IS

Recently, we've come across agencies that have received valuation estimates based on very high multiples of EBITDA – in a couple of cases, more than 10x! For example, one agency had an EBITDA of $323,000, and a broker told them they were worth $3.5 million. Let's look at the practical side of this too good to be true approach to value.

If you're an agency earning $1 million, a 10x multiple equals a price of $10 million. What does this mean from a buyer's perspective?

First, let's assume that your bottom line grows by 10% every year for the next 10 years. I think we'd all agree that's a very healthy projection. Now, keep in mind that the buyer is using after-tax dollars to fund her purchase, so let's say that the after-tax EBITDA is 65% of the pre-tax (assuming a 35% effective total tax rate). Applying these assumptions of 10% growth and 65% return after taxes, after 10 years, the buyer would only have generated $9,709,326 from the $10 million spent to acquire your agency. 10 years, and they still wouldn't have recouped their investment!

Admittedly, the buyer isn't going to pay the full amount at closing, so the picture isn't quite as bleak as I painted in this example. However, the numbers show that sky-high multiples just don't make economic sense.

What this means for you is that it's important to work with an advisor who really understands the market and who isn't going to give you an inflated – and unrealistic – number for the sake of getting your business. Realistic expectations and the chance of a pleasant surprise at the end are much better than investing your time, money, and emotional capital into a sales process based on a value that will inevitably disappoint.

WHAT TO DO NEXT

If you're curious, get an estimate for your agency value. But then, what do you do if there's a big gap between what you'd be willing to sell your agency for and what it's likely to bring? That's the time to learn about other options – from selling to employees to implementing a strategy for building value to retaining control and instituting incentives for others to manage the business. To help with those decisions when the day inevitably comes for an exit, it's important to have an Exit Plan in place that will enable you to be proactive and drive the results that you want to achieve.

CLICK HERE for TobinLeff White Paper on Exit Plans

So, what's your agency worth? At the end of the day, it's what you and a willing buyer agree to. And at TobinLeff, it's our job to get you there. Give us a call (412/515-0120, ext. 102) or email me at sleff@tobinleff.com to find out more about how we do that.

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About TobinLeff, LLC

TobinLeff is an M&A advisory and exit planning consulting firm that helps owners of marketing, advertising, PR, digital, IT, and related companies build and monetize business value. On the build side, we:

- craft Value Enhancement Plans,
- deliver strategic consulting and implementation services, and
- provide M&A services to source, structure, negotiate, and help close acquisitions and acqui-hires.

To help clients convert business value into personal wealth, we:

- craft Exit Plans,
- design and implement Management Buy-Out Plans, and
- provide M&A services to source, structure, negotiate, and help close sales of client companies to outside buyers and private equity groups.

Now in our 10th year of service, we have assisted more than 125 owners with exit planning solutions and M&A transactions to buy and sell companies. All of our partners have owned marketing agencies. We are based in Pittsburgh with partners in New York, Orange County, and North Carolina.

Please visit our site at www.tobinleff.com for additional information and case studies.

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