Business valuations

Why all values are not created equal

INTERVIEWED BY ROGER VOZAR

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How can a business be worth both $1 million and $700,000? It depends on what type of value is being determined.

"A business owner may think that if a business has a value of $1 million, it means that he would have $1 million in his pocket upon a sale. One must look deeper, however, and determine what type of value the $1 million represents. A number alone isn't enough, you need to define what value you are trying to determine because there are different definitions of value," says Robert A. Ranallo, CPA/ABV, JD, CVA, CFF, a partner at Skoda Minotti.

Smart Business spoke with Ranallo and Sean Saari, CPA/ABV, CVA, MBA, a principal at Skoda Minotti, about the various ways of determining the value of a business.

What different types of value are there?

The value most commonly determined is equity value, which represents someone's equity ownership interest in a company, whether it's 1 or 100 percent.

Another value that may be determined is enterprise value, which is equal to the equity value plus debt, minus cash. Alternatively, an enterprise value can be converted into an equity value by subtracting debt and adding cash. Investment bankers often discuss enterprise value because they're concerned about the company's total value, regardless of how it is financed (debt versus equity).

Let's assume in the example that the $1 million represents enterprise value and the company has $400,000 in debt and $100,000 in cash. An investment banker would likely say that the company's value is $1 million, but the owner's equity value (the net amount that the owner would receive before taxes) is only $700,000 ($1 million enterprise value - $400,000 debt + $100,000 cash).

Misunderstandings result because people often talk about values in terms of multiples — 'A company in my industry sold for five times EBITDA (earnings before interest, taxes, depreciation and amortization).' Because EBITDA is before interest, it doesn't take into account the impact of debt, so the resulting value is an enterprise value (which includes debt), not an equity value.

What are standards of value?

There are several. The most frequently used is 'fair market value,' which is required for valuations prepared for the IRS, divorce courts or other situations where the parties need to determine the value at which an ownership interest would transfer between a willing buyer and a willing seller.

Another standard of value is 'fair value' for financial reporting purposes. Fair value is often synonymous with fair market value, although there are some definitional differences.

There is actually another fair value standard that arises in a legal context in cases involving dissenting shareholders. The difference between legal fair value and financial reporting fair value is that legal fair value typically does not include adjustments for factors such as lack of control and marketability, although this can vary by state.

There also is a strategic, or investment, value. This standard of value is typically used in connection with transactions when a buyer is purchasing a company in its industry. Under this standard, adjustments are made in the analysis that is specific to the particular buyer, such as the elimination of duplicative expenses after the transaction.

What does 'level of value' mean?

Level of value relates to the control and marketability characteristics of an ownership interest. Controlling interests in privately held businesses are more valuable than minority interests. A controlling owner can unilaterally dictate the operation of the business, sometimes to their benefit and the detriment of the minority shareholders, including controlling the sale of the business and distributions of cash flow. Absent agreements with minority owner protections, a non-controlling owner is just along for the ride, which makes these ownership interests less valuable.

As for marketability, privately held businesses do not have a ready market for sale like publicly traded ones, so certain discounts are applied to reflect this impairment on value.

With different valuation considerations, remember that when you talk about valuing a business, all parties need a clear understanding of the value they are seeking. This will eliminate misunderstandings and hard feelings down the road. ●