Six Reasons for a Business Valuation

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Preparing a valuation for your company is a little like having a thorough physical examination on yourself with lots of x-rays and blood tests. The business valuation, if it is prepared by someone who knows your industry, can be an excellent way to get an expert's opinion on how well your company is being run compared to national industry averages.

There are plenty of reasons to have a business valuation prepared for your company. I wanted to provide you with six ideas on how the valuation could be the most beneficial to you:

#1 Selling to Family or Key Employees – If you are planning on selling your company to a family member or to a key employee, a business valuation is a necessity. The valuation will consider which assets are being sold, and which assets will be retained by the seller. For example, the seller may be the older generation. That generation may keep some of the business's excess cash. If the company belongs to a national purchasing cooperative, the current owner may also keep the value of the patronage stock.

The usable cash flow, or EBITDA, is one of the most important calculations in a business valuation. It will show the next generation how much cash flow they have to work if they are going to 1) look for financing for part of the purchase price and/or 2) pay on a promissory note to the older generation for the purchase of stock. The valuation is providing perspective to both the buyer and seller depending on how the sale of the company is financed. Moreover, the business appraisers will need to know the details of what the plan looks like between the older generation and the younger generation. If the usable cash flow changes during the three to five year transition, then those changes could impact the business appraiser's valuation. Is the older generation going to reduce their salary and bonuses to zero, or perhaps take a 50% reduction in pay? Is the ownership transition going to take three to five years, or longer? These questions can be answered better if a valuation has been prepared.

If the business owner is selling to one or more key employees, the same questions must be asked. What assets is the seller going to keep, and how much usable cash flow will the key employees have to work with in order to purchase the stock in the business.

Over the years of speaking with owners, I have always said the assets of the company are very important, but the usable cash flow is *more* important.

#2 Selling to an Outside Party – If you are selling your business to another company within your industry, the business valuation experts will, again, need to know what assets are being sold and will need to determine the

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"usable cash flow". The calculation for the usable cash flow, or adjusted EBITDA, will be different for an outside sale relative to the sale to a key employee or family. If the business owner is going to sell the company and leave immediately, there would probably be a higher level of EBITDA which means the company could have a higher value.

The analysis in a business appraisal report can also be used by the seller in determining a selling price and help communicate the selling price of the company with a potential buyer.

The buyer will be very interested in reviewing all of the assets that they will be purchasing and they will want to thoroughly analyze the amount of usable cash flow that this company can produce.

A well-prepared business valuation report becomes a valuable tool for the seller and the buyer as they discuss all of the terms and conditions for selling the company.

#3 Improving Value – If you have decided to sell the business three to five years from now, many owners use a business valuation as a tool to monitor the progress of their transition or "exit" plan.

For example, the business owner could increase the value of the company by increasing gross margins 1% or 2% each year during the three to five years prior to the sale of the business. They may also try to reduce expenses or may reduce obsolete, or slow moving inventory.

By having a business valuation report prepared, three to five years early, this gives the business owner a health report on the company. Then, every twelve months, they have the business valuation updated with a minimum amount of cost, by the same valuation experts, using the same formulas and methods. This gives the business owner a status of the company and how well the owner is doing on developing their exit plan. Just like going to the doctor and getting a physical every twelve months, all the information the doctor gives you is important information on how well you are doing.

Getting an annual checkup on the company during the last three to five years, can be a valuable tool, to not only make the company healthier, but also increase the selling price substantially.

#4 Estate/Probate – Unfortunately, a business valuation is usually required when a stockholder of a privately-held company dies. The business valuation is needed not only for the estate planning, or probate process, but it may also be required by the company buy-sell, or stock redemption agreement.

Also, if a stockholder is in the process of getting a divorce, the attorneys and both spouses will most likely need a business valuation which can be used in any negotiations for property settlements.

#5 Buy/Sell Agreements – If there are two or more stockholders in a business, it is usually a good idea to have a business valuation prepared when stock redemption agreements, or buy-sell agreements, are signed for the first time. Then, every one or two years the valuation report can be updated with a minimum amount of cost in order to provide the updated valuation for the stock, which is used to update the stock redemption agreement. This way, all of the stockholders know the value of the stock and how the valuation was calculated.

#6 Retirement & Contingency Planning – A valuation report may also be needed to value the shares in case one of the stockholders is officially retiring from the company. In order to buy out the retiring stockholder, the updated value of the stock would be an important requirement.

Also, if one of the stockholders becomes disabled and unable to perform their duties and can no longer be an ongoing important employee of the company, for disability purposes, a business valuation becomes important.

Sometimes a stockholder may wish to sell a few shares if they have a need for cash. If cash is needed for medical purposes, or perhaps paying for college expenses, selling a few shares of stock in the family business may be one option for raising cash.

A well-written business valuation report that thoroughly analyzes the true value of the business, can be a very crucial tool for any business owner who may be involved in any of the six ideas discussed above. A well-written report which analyzes your company and compares it to your industry and national benchmarks, is no different than you going to the doctor once a year and getting x-rays and blood tests to monitor your own personal health.

If you think that any of these scenarios are applicable to you, having a business valuation prepared might be a good option, and it will also help the business owner and any minority stockholders in their decision making process.

Gary Pittsford, CFP®, is President and CEO of Castle Wealth Advisors, LLC. Castle specializes in helping families and closely-held business owners with valuations, succession planning, estate and income tax analysis and retirement income security. Castle's senior partners work with clients throughout the country in making logical decisions that help them fulfill their personal and business financial goals. For more information visit www.Castle3.com, call 1-888-849-9559 or e-mail Gary directly at Gary@Castle3.com.