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Setting the Stage . . . This Business of Valuing Small, Closely Held Companies

Mary said to me, ''I got a deal! I bought 'X' and I paid 'Y' dollars for it!'' *My perception* of her deal compelled me to say, ''**You paid what?!**'' As you already know, each person's observation of the same event can *normally* be counted upon to be quite different. This, of course, is true about value in small companies.

We must let go of old assumptions that we know how things work regarding price and value in small, closely held companies. We really don't. For one thing, the earmarks of entrepreneurs are their independence and nonconformance with traditional practices. Quite frequently, they will be found never agreeing on anything from the past. For another, they are not bound by the decisions passed down by a corporate board of directors.

The *model definition* of fair market value used by most professional appraisers tends to revolve around several connected definitions provided in *Black's Law Dictionary*. The terms ''cash market value,'' ''fair market value,'' ''reasonable market value,'' and ''fair cash market value'' are substantially synonymous terms and *mean the highest price the property would bring free of encumbrances, at a fair and voluntary private sale for cash*. At first blush, this crisp and straightforward concept seems rather easy to understand.

I'd now like you to read this same definition with its inherent conceptual fallacy exposed . . . and, also, present it in the light of the small-company transaction.

> 'Fair market value' (FMV) is not designed with any particular individual in mind, nor the 'real' transaction for that matter. FMV is a hypothetical value for the 'model' transaction. The governing conditions in this ideal concept are *full knowledge* and *freedom to act*. But in reality, these ideal conditions are rarely present. Emotional

> and subjective elements often override rational considerations, and *full knowledge is something rarely attained by the arm's-length potential buyer* who previously has not been involved in the business. Thus, the necessary conclusion is that few buy/sell transactions involving closely held small businesses are done at so-called fair market values. (Summarized from comments of T. S. Tony Leung, C.P.A.)

When my editor at John Wiley & Sons, Inc., Mike Hamilton, asked me to do a book on valuation, I was left with two choices: to write strictly as a technician and be similar to most competing works, or to reach into people-driven factors of how deals *really* go together as far as pricing is concerned. You will soon learn that this was not really an option for me. And, subsequently, the work of this book is akin to the preceding description by Mr. Leung.

However, the ''stage'' for inclusive discussion will be less than complete until we bring some of the more commonly found *myths* surrounding business valuation and pricing into view. I make no attempt to rank these in any particular order or to set precedence in how buyers and sellers might emphasize them during their negotiating processes. All are covered thoroughly in this book, including how these myths can and do creep in to complicate a reasonable and fair settlement on price between the principals in deals.

Myths Commonly Associated with Business Value

Myth #1: The value of a closely held company is based on its ''future'' earnings.

There is absolutely no question that intrinsic decisions reached by buyers are deeply steeped in the prospects for earning livings beyond the dates of their purchases. But the fact is also that buyers expect to pay no more than the ''present value'' of those earnings on the dates of those transactions.

Discounted cash flow (DCF) methodologies are developed to analyze values in light of a business's future earnings. Simply described, these formulas consider business earnings for a number of forecasted years into the future; quite often, 10 years are used. Earnings are then ''discounted'' back to ''present'' value (value of future earnings stated in today's dollars). I have absolutely no qualms about the basic principle in this formula, and, as evidence of its goodness, it is frequently the method of choice in valuing

publicly traded companies. Its use in valuing closely held companies, however, gives me more than moderate anxiety.

General Motors booked over $15 million of sales per *clock hour* in 1994. Even if sales sputter and are off by a million or so per hour, there is still a whopping annual sales volume left over. According to my studies of recent years, it is estimated that 74% of small, closely held companies in America realize under $1 million of sales *per year*. Most of these businesses struggle year after year just to make ends meet. For the most part, in valuing small companies, I cannot subscribe to methods that project values based on future earnings for businesses that breathe a sigh of relief when just *meeting* last year's sales! And I assure you, neither do most buyers. Bear in mind that regardless of what product, service, or entity we sell, ultimately it is the *consumer who will decide* whether we survive or fold. That consumer of the smaller company's goods and services is quite likely to be inordinately ''attached'' to the personality and characteristics of a past owner. Detach him or her from the business and what the replacement owner inherits may not be a suitable match in terms of today's value.

Regardless of the benefits I have received from formal education in psychology, accounting, industrial science, and mathematics, I still puzzle occasionally about the use of financial tables, as many expert technicians also do. Formulas, like languages, if not used daily can cause even the competent mind to wander and fail periodically. Try reading the 846 pages in *Handbook of Financial Mathematics, Formulas and Tables* by Robert P. Vichas (Prentice-Hall), if you doubt my concerns over formula usage! My point: Mastering DCF methodology is beyond the reach of the vast majority of periodic users. Unless the processor routinely and repetitively uses DCF, it is unlikely he or she will be able to collect and consider all the ''character'' and market variables in the proper light. Future earnings, discounted or not, belong to the owners taking the business into those future events. Thus, the message for sellers is simple—if you want future values, stay with your businesses, make the future happen, and depart when you've reached the target value of choice. The message for buyers is also simple—don't pay prices today that are based solely on future earnings. By the same token, don't buy a business that cannot foresee earnings in the future.

Myth #2: Real property and other hard asset values are always ''add-ons'' to business cash flow values.

Business ''facilities'' in the context of enterprise are no different per se from other required operational hard assets in terms of cash flow. In other words, the business ''value'' treats real estate, owned or leased, in the same

way as furniture, fixtures, and equipment for the purposes of the valuation assignment, because facilities are as necessary to the operational function as are equipment and other hard assets. However, one should always appraise real estate as a stand-alone value, because it can often be sold with or without the business and because real estate ownership usually comprises the most valuable of business assets. It can also be the asset least affected in its value under the ''hammer'' of liquidation and can be the most viable asset pledged as collateral in terms of financing or refinancing the business as a whole. But real estate values *are not* add-ons to business values predicted through cash flow analysis. Cash flow value determinants predict what ''can'' be paid for the real estate, but not ''what'' the real estate is worth in market terms.

Market values of real estate and other hard assets collectively can enhance or negate the values of the business as a whole. When cash flows will not support the purchase of hard assets, including real estate purchase or lease, the prospect is strong that there is no remaining business value to discuss. Thus, we might have no more than an ''asset'' sale . . . and no real business to sell. The purchase of hard assets that are ''excessively'' supported by cash flows (cash flow inclusive of debt service *and* a new owner salary and profit), however, will enhance business values in the nature of both purchase price and financing terms. You'll see this more clearly as we move through several exercises later.

Myth #3: You should always press for all-cash deals.

Granted, this might be desirable, but the fact remains that better than 70% of all closely held transactions contain some element of seller financing. Thus, wanting and getting may not be an option for most, and ''pressing'' too hard and too long for cash-out may translate into no deal at all.

Structuring ''installment'' sales has tax benefits that should not be overlooked. As long as constructive receipt is divided into at least two tax years, capital gains tax may be less under present laws. Considering present legislative discussions, capital gains and depreciation treatments may even get better. The key to safety in private financing arrangements is to ''know'' player histories well and to recognize the strengths and weaknesses proposed in the deals themselves.

An all-cash requirement lowers purchase price. Financing, private or institutional, can assist or raise havoc with the price. Some sellers are willing to substantially discount business values for all cash, but many more will not be so willing. The statistics are against ''getting your cake and eating it'' at closing—concurrent with a price that may be all that your business is truthfully worth.

Myth #4: The darker ''their'' sunglasses, the more you'll receive.

Keeping a serious buyer in the dark about the reality in available cash flow, value, price, and terms sets the stage for personal disasters for both seller and buyer. Disproportionate outlooks will grow unmanageably through unchecked perceptions, and if the courts don't give a blow to the head, the ultimate settlement structure might. If you want to enjoy or walk away from a deal without looking back, the only safe assurance is in keeping the match open and on equal footing. Everybody has problems of one sort or the other. Share them . . . after all, one of you is selling, the other buying, and sharing may represent all the help you need to do your deal with safety. Dark conventional sunglasses keep out light, but they won't protect you from dangerous ultraviolet rays. Keeping secrets about the business's prognosis will rarely sweeten the pot permanently.

Myth #5: If I set the price high, I can always drop it.

Yes, you can, but can you do so soon enough to capture a sale? Pricing in its relationship to a marketable time frame is an issue in business valuation. Too low on the price, and a business sells too quickly in relationship to value. Too high, and it sells too slowly or not at all. Ever notice how shelved products get ''ratty'' and dusty when they move too slowly? They fail to be appealing when they get into this condition, and either they must be heavily discounted to be moved, or they can't be sold at all. Believe it or not, the same thing happens to small businesses. A price must be kept in line with the specific marketplace for that value to perform outside of wish-list expectations. Pricing, timed appropriately to the market, *protects* maximum value achieved.

Myth #6: If I make a low-ball offer, I can always go up.

Yes, you can, but the ''sledding'' from an undignified low-balling position is never easy. Everybody wants to buy low and sell high, and some do, but the overall problem with this concept is that *everybody* wants to do it. Low-ball offers tick people off! They also set them into fortified trenches. Emulate lost cooperation, and you'll likely lose out on the deal. Make a reasonable offer, or pass.

Myth #7: Third-party evidence calls the shots.

Don't you believe it! Buyers and sellers have their own private agendas, and valuation specialists are no more or less acceptable to the players than are accountants and lawyers. The closely held arena is *filled* with I-want-to-gain motivations (often quite rigid individual motivations of both buyers and sellers), and third-party advice is frequently considered no more

valuable in negotiations than the contents of a baby's messy diaper. What it adds is the starting point for discussions—but you can count on negotiations being steeped deeply in ''I-want-to-gain.''

Myth #8: Choices for small-company buyers and sellers are like picking stones from the ground.

It is estimated that more than a million businesses are for sale on the U.S. market annually. Nice numbers. But take a hard look at the numbers. About 300,000 companies actually sell, and about 255,000 that do sell are very small businesses. We can draw some conclusions from these estimates—although sellers are aplenty and buyers are abundant, four out of five businesses do not sell. Of those that do not sell, 52.1% pass into bankruptcy or fade into oblivion. Something is wildly wrong with an 80% failure rate (four out of five not selling). Is it stubbornness in pricing? Is it unreal objectives of buyers? Is it undesirability of the businesses themselves? What is it that causes this failure of buyers and sellers to complete transactions? My best guess is that someone's *value system* is on the blink . . . at least four out of five times.

The acts of buying, selling, and pricing the small company are laced with many myths that serve no good to anyone. In many respects, these myths are rooted in the same market capitalism of bigger business, but in the smaller realm they are dominated by profit-driven *private* firms and *private* consumers. Instability, insecurity, and excess are inherent. Sellers overpromise and generate distrust in buyers. Buyers over- or underestimate their capacity and generate this same distrust in sellers. People who buy and sell small companies often indeed find the process itself inadequate.

The Small Business Administration's (SBA) at-or-under-500-employee model for small business fails to reach down to the needs of the approximately 89% of all American businesses that employ 20 and fewer people. Until 1978, when Babson College, in Wellesley, Massachusetts, developed the smaller entrepreneurial teaching model (now cloned to some greater or lesser degree in nearly 400 colleges and universities nationwide), our educational system taught us the ways of big corporate America. Learning about smaller business was left to the classroom of hard knocks. Yet we have been expected to overlay all the teachings of big business onto a very small arena that doesn't follow these corporate rules. No wonder myths developed. You might want to take a good look at my other two books

as well: *A Basic Guide for Buying and Selling a Company* and *Self-Defense Finance for Small Businesses*. You *can* correct the myths and do your deals!

> "Small—*If you think you are too small to be effective, you have never been to bed with a mosquito.*"
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> Betty Reese