The Business Library® — Resource Report #2

How to Determine the Dollar Value of a Business

- Profile of Marlow Electronics, Inc.
- Adjusting the Financial Statements
- Balance Sheet Values
- Income Statement Values
- Summary of Valuation Methods
- Final, Weighted Value
- Other Valuation Methods
- How to Increase the Value

THE BUSINESS LIBRARY™

Table of Contents

A special niche, be it a product, distribution method, location, or geographic area covered, can substantially increase the business' value.

Terms and Concepts to Know

Cash Flow. If a company's net income is $100,000 and its depreciation and amortization expenses are $30,000, its cash flow is $130,000.

Earnings per Share (EPS). If a company's net income is $100,000 and there are 100,000 shares outstanding, the earnings per share is $1.00.

EBIT. Earnings *before* interest and taxes. EBIT is basically a company's operating profit. If we add depreciation and amortization expenses to EBIT, it's referred to as EBIT+D+A.

Price-Earning's Multiple (p/e). The p/e multiple is the market value of a company's common stock divided by its earnings per share. For example, if the market value of a stock is $20 and the EPS is $1, the p/e multiple is 20.

Capitalization Rate. The reciprocal of the price-earning's multiple, e.g., if the p/e is 20, the CAP Rate is 5% (1 divided by 20).

* * *

This **Resource Report** was written by Thomas J. Martin, author of *The Business Library*. Mr. Martin is an investment banker, valuation expert, and the author of several valuation and finance books. Over the last 30 years, he has presented scores of workshops for business associations, accounting firms, banks, and other organizations on valuing, buying, and selling businesses.

Case Study Results: **The adjusted tangible net book value of $565,000 is the *minimum* value for Marlow Electronics. The *maximum* value is the $936,000 derived from the multiple of operating profits method. That's a difference of $371,000 or 66% in the value of the same company using different valuation methods.**

Do You Know What Your Company Is Worth?

The best reasons for valuing your business lie in what can happen if you don't.

■ Our first owner, age 66, was selling his 100% ownership in the company he founded to two of his executives. The initial discussion focused on an asking price of $950,000. After adjusting the company's reported earnings and the balance sheet, the asking and final selling price came in at $1,350,000 — *42% more than the owner's original assumed value of the business.*

■ A second business owner owned 100% of his business and a real estate affiliate when he died without a will three years ago. His records included no valuation documents, no estate or succession plan, and no buy-sell agreement. This owner's lack of foresight and planning cost his heirs $1,240,000 in federal estate taxes and $385,000 in state inheritance taxes.

■ A minority stockholder, who owned 4% of a company with a total stockholders' equity account of $195,000, sued the two majority stockholders for their exorbitant salaries and misuse of corporate funds. A court-mandated buy-out of the minority owner's stock was ordered and a valuation of the business was prepared. In the end, the company paid out $227,000 to buy back the 4% ownership.

■ When the principal owner (55%) of one business died, his family had to sell its controlling shares to outsiders at a 32% discount. The other owners (45%) could not afford to buy the family's shares and there was no mechanism in place, e.g., a buy-sell agreement, to help the heirs sell all or part of their 55% ownership.

Establishing a value for your business in advance of major disasters or decisions will help you avoid such costly mistakes. A well-documented, justifiable valuation will maximize the cash you receive when selling out, help a successor run the business on your disability or death, effect ownership gifts and transfers to family members, and reduce potential estate taxes for your family and heirs.

But the task of setting a value on a business is compounded by the fact that there are many different ways to value a closely held business, reflecting the many different motives for a valuation. For example, you want a high valuation when you're selling your business and a low valuation when you're gifting or transferring stock to your

children or planning for potential estate taxes.

The solution is to use several valuation methods and then apply a "weight" to each method to determine a *final, weighted value* for the business. That's what this report does. Through an *actual* case study, it explains and illustrates the principal methods of valuing a business and then it shows you how to use weights to determine a final value for the business. Read the report carefully and save it for future reference.

Thomas J. Martin, *Author*

Axiom: **The higher a company's growth rate, the higher the p/e and EBIT multiple you apply to the company's profits.**

The Valuation Process

1. Define what is to be valued — an asset, division, or the entire company.

2. Analyze and adjust all financial data for the last five years.

3. Prepare a reasonable projection of sales and profits for the next three years.

4. Select the valuation methods to be used.

5. Compute each valuation method.

6. Weight the values, e.g., 40% to adjusted net book value, 30% to the price-earning's value, and 30% to the operating profit's value.

7. For minority ownership positions or projected estate values, apply a discount to the values, ranging from 20% to 40%.

Case Study: Marlow Electronics, Inc.

- *Business:* Manufacture of electronic components for the cable and telephone industry. The company is a regular (C) corporation which was formed in 2006.
- *Ownership:* 75% by Robert Marlow and 25% by James Milburne. There are no stock option plans in effect to acquire the company's common stock.
- *Purpose of the Valuation:* Preparation of a Buy-Sell Agreement and Confidential Review of the company for its potential sale.

Income Statement Data and Projected for Year 2017

Year	Sales	Operating Profit	Net Income
2017 — Proj.	$1,100,000	$172,000	$ 94,000
2018	970,000	140,000	74,000
2019	50,000	102,000	65,000
2020	10,000	85,000	52,000
2021	520,000	46,000	31,000
2021	460,000	32,000	22,000

Balance Sheet Data — as of December 31, 2016

Current Assets	$ 855,000	Current Liabilities	$ 450,000
Net Fixed Assets	225,000	Bank Loan	250,000
Other Assets	20,000	Stockholders' Equity	400,000
Total Assets	$1,100,000	Liabilities and Equity	$1,100,000

How to Put a Price Tag on the Business

What's the value of my business? Jot a quick estimate on a piece of paper, then pose the same question to your accountant, lawyer, insurance agent, treasurer, and even your spouse. You will be amazed at the range of responses and values. *Why?* Because a valuation can be viewed from many perspectives:

- What's the value as a going concern if I want to sell out?
- What value do my partner and I establish for use in a buy-sell agreement?
- How is the business valued if I want to raise capital by adding minority owners or going public?
- How will the IRS value my business after my death? Or when I gift some stock to my family?
- How do I value options to buy an ownership position in the company as an incentive for my key executives?

There's also a highly subjective, personal value — the company's value to me as an operating business that provides me with a comfortable *after-tax* salary and liberal benefits while permitting me to manage as I choose without reporting to anyone.

Then there's the related question — what is the business worth *without* me?

Valuing a business can be complex but it does come down to a dollar sign and a number in the end. Let's start with some basic values and then build on those values to determine a final price tag for the business. This will include "weighting" the different valuation methods used to come up with a single, defensible dollar figure. An actual case study (name is fictitious) will be used to illustrate the concepts and steps.

Applications: Don't worry about the legal form or size of the company. The concepts in this case study apply to all ownership positions in regular (C) corporations, S corporations, limited liability companies, partnerships, and sole proprietorships. You will also find the methods applicable when valuing a product line or division of your own company or another company you want to acquire, as well as when valuing a service business. Now to our case study.

* * *

Marlow Electronics, Inc. was formed in 2006 by Robert Marlow (75% owner) and James Milburne (25% owner) to manufacture electronic components for the cable and telephone industry. For the year ended Dec. 31, 2016, the company showed sales of $970,000 and net income of $74,000. For 2017, management is projecting $1,100,000 sales and $94,000 net income. Its balance sheet as reported by the company's accountant in its latest financial statement was as follows:

Assets	$1,100,000
Liabilities	$ 700,000
Stockholders' Equity*	400,000
Liabilities and Equity	$1,100,000

* Also referred to as a company's net worth and net book value (NBV).

Now to our basic valuation methods.

#1. Balance Sheet Values

The objective is to determine Marlow Electronic's adjusted tangible net book value, which starts with its *reported* net book value, subtracts *intangible* assets, and then *adjusts* specific assets and liabilities to their fair market value.

Reported and Tangible NBV. We will use these two values and then adjust the Tangible NBV to a fair market value.

Reported Net Book Value (NBV)	$400,000
Less: Intangible Assets	25,000
Tangible NBV	$375,000

Valuation comments: The $25,000 of intangible assets consisted of deferred financing and start-up costs. *Reason for subtraction:* The cash has already been outlayed. These assets were capitalized on the balance sheet by the accountant to be written off over future years, e.g., the deferred financing costs over the life of the company's term loan.

Adjusted Tangible NBV. We now adjust for assets which have fair market values in *excess* of their reported book value. In analyzing Marlow Electronics' balance sheet, we find the value of the following assets understated:

Asset	Reported	+	Excess Value	=	Adjusted Value
Inventory	$230,000		$ 60,000		$290,000
Equipment	140,000		80,000		220,000
Other Assets*	20,000		50,000		70,000
Totals	$390,000		$190,000		$580,000

* Principally assets and costs (some previously expensed) which have values in excess of their reported net book value, e.g., customer and mailing lists.

The excess values total $190,000. Thus, the company's *adjusted* tangible net book value is:

Tangible NBV	$375,000
Excess Values	190,000
Understated Liabilities*	0
Adjusted Tangible NBV	$565,000

* Here you subtract any liabilities not shown on the balance sheet, e.g., unfunded pension costs and unresolved litigation.

Valuation comments: The adjusted tangible NBV of $565,000 — usually the *minimum* value for a business — represents a 41% increase above Marlow's reported NBV of $400,000. In many cases, owners use this adjusted NBV when setting a price in a buy-sell agreement or stock option plan for executives.

Now that the assets have been valued, we can move to the company's income statement, which reflects where the company is today and where it's headed.

#2. Income Statement Values

The job of coming up with a dollar value for a business is complicated by the fact that there's no single right dollar amount nor any single right method for arriving at it. That's because there are a great many variables in establishing the value. One of the variables you will confront in calculating these income statement values is the multiple. Multiples are referred to either as a price-earning's multiple (p/e multiple) or an earnings before interest and taxes multiple (EBIT multiple). Multiples are applied to income and earnings figures in various valuation methods to come up with an overall value for a business.

The problem for owners is that the multiples used vary widely. Price-earning's multiples, which are applied to net income, for example, can range from 8 to 15 and even as high as 30. EBIT multiples usually range from 4 to 8 but can be as high as 12. In both instances, the highest multiples are justifiable only in particularly fast-growing (i.e., 25% growth rate), highly profitable companies.

Note that the EBIT multiple is always lower than the p/e multiple because it is applied against a higher income figure (earnings *before* interest and taxes) than the p/e multiple, which is applied to net income (*after* interest and taxes).

Generally, the p/e multiple is applied more often to publicly held companies since it's easier for investors to use and the EBIT multiple to privately held companies since it better reflects the *operating profits* of a business before interest and taxes. The owners of closely held companies tend to minimize profits and taxes as much as possible so net income is a less revealing figure than the company's gross or operating profit. How to Adjust a Company's Financial Statements is explained later in Exhibit 2, page 20.

Now to our next two valuation methods. The objective is to value the company's net income today and projected using the following valuation methods.

Price-Earning's Multiple Value. Based on Marlow's net income of $74,000 for 2016 and the projected $94,000 for 2017, the following is computed:

Average 2016 and 2017 Net Income	$ 84,000
Price-Earning's Multiple (p/e)	x 8
P/E Value	$672,000

Capitalization rate: The reciprocal of the 8 p/e, which is 12.5% (1.00 divided by .08), is called the capitalization rate (CAP rate). You also can arrive at the $672,000 value by dividing the average $84,000 net income by the 12.5% CAP rate.

To better understand the 8 p/e and 12.5% CAP rate, consider the following. If the company were to pay out in dividends 100% of Marlow's average earnings of $84,000, the return to its owners (or new investors) would be 12.5% ($84,000 net income divided by the $672,000 value). That's not an unreasonable return for owning stock in a closely held business. *Reasons:* The shares cannot be readily sold in the public market (referred to as illiquidity) and management usually doesn't pay dividends since they're not tax deductible and dividends drain cash that could be used for working capital and growth. Furthermore, compare the 12.5% return with owning shares in a larger, publicly held company with characteristics of size, management depth, good customer distribution, easier access to capital, and low debt-to-equity ratios. Wouldn't you want a minimum return of 12.5% (paying no more than 8 times earnings) if you were investing in a closely held business that didn't have those characteristics?

When is a higher price-earning's multiple justified? In fast-growing companies whose earnings today do *not* reflect their real potential value. Here, the p/e can be as high as 15 to 20 times last year's or next year's earnings. If Marlow were in this category, the $84,000 average earnings, using a 15 and 20 p/e, would be valued at $1,260,000 to $1,680,000. Compare that to the $672,000 value computed above.

Note that the CAP rates for the 15 and 20 p/e are 6.7% and 5%, respectively. In these cases, investors are willing to accept a lower *current* return since they expect earnings to increase significantly over the next few years, which hopefully will mean a much higher price for the stock in the future.

Axiom: The higher a company's growth rate, the lower the current return (CAP rate) an investor is willing to accept on an investment, and thus the higher the multiple paid to own that investment. That's why some investors, prudent or not, have paid 30 to 50 times earnings for fast-growth, high-tech companies trading in the public marketplace. In fact, brokers sometimes recommend buying growth stocks at p/e multiples as high as the company's growth rate. If the growth rate is 30% a year, the p/e also can be 30.

Multiple of Operating Profits or EBIT Value. This value is determined by multiplying Marlow Electronic's earnings *before* interest and taxes (EBIT or Operating Profits) by a factor (multiplier) ranging from 4 to 8; the median is 6. Here's the value.

Average Operating Profits	$156,000	*
Multiplier	x 6	
EBIT Value	$936,000	

* Average of $140,000 (2016) and $172,000 (projected 2017).

Valuation comment: Again, you can use the upper EBIT multiplier of 8 if your company's growth rate is high, say, 25%-plus, and your fundamentals are in good order, e.g., solid balance sheet, above-average returns on sales and stockholders' equity, good customer distribution, good second-line management, etc. For more ways to increase the multiple and value of the business, see page 23.

Final, Weighted Value

The final step is to list the valuation results from each method and apply a "weight" (percentage allocation) to each value. Here's how to do that.

Valuation Method	Value [1]	Percent x Weight	=	Adjusted Value
Adjusted Tangible NBV [2]	$565,000	40		$226,000
Price-Earning's Multiple Value	$672,000	30		201,600
Multiple of Operating Profits	$936,000	30		280,800
Final, Weighted Value		100		$708,400

(1) The average of these three values is $724,333.

(2) We did not include Marlow's reported NBV of $400,000 and the tangible NBV of $375,000 since these values are within the Adjusted Tangible NBV above.

Valuation comment: The higher 40% weight was applied to the adjusted tangible NBV method because this asset value is more certain than the two income statement values. However, if the company's current earnings level and its projections, rather than its assets, better represent where it is today and where it is headed, rather than where it's been, you can weight the income methods higher, e.g., 40% each, and give 20% to the adjusted tangible NBV method.

Value Comparisons. As computed in the table above, the final value of Marlow Electronics is $708,400. To test the reasonableness of the $708,400 value, we now want to compare that value to other values.

1. The average of the three values is $724,333, which represents 102% of the final value of $708,400. That's good. If the average is more than 125% or less than 75% of the final value, recheck your valuation calculations and the percentage weights applied to each method.

2. The final value of $708,400 represents 1.8 times Marlow's *reported* net book value of $400,000. That's typical, but the final value can range from 1.0 to 2.5 of a company's reported net book value.

3. The final value of $708,400 represents a p/e of 9.6 times Marlow's 2016 net income of $74,000 and 7.5 times 2017 projected net income of $94,000. That's reasonable for smaller, closely held businesses.

4. The range of values is $565,000 to $936,000 with a median value of $750,500, which is 106% of the final value of $708,400. That provides further support to the final value. You also may want to add and include other valuation methods, discussed below.

Minority Discounts. The final value of $708,400 is *before* any discount for minority ownership positions. If you have minority owners, here's how to adjust your company's final, weighted value. A 20% discount can be applied to stock owned by minority owners since they don't exercise control, generally don't receive dividends, and can't sell their shares since the company is not public. To illustrate, let's look at the 25% ownership held by James Milburne. The value of his stock holdings is computed as follows:

Total Value of Business	$708,400
Value of 25% Ownership Position	$177,100
Application of 20% Discount	-35,420
Net Value of 25% Ownership	$141,680

That same 20% discount can be used for other minority ownership positions, including stock gifted to family members directly or through a family limited partnership or other trust, and the option price in a stock option plan for key executives. The discount also is applicable to shares owned by an estate, but in this instance, the discount can increase to 30% to 40% since the principal owner and drive behind the business is no longer around.

Other Valuation Methods to Consider

- *Replacement value:* This method adjusts all of the company's assets to their replacement value and then subtracts the liabilities. Because of inflation and the annual depreciation of assets, the replacement value can *substantially* increase a company's value and is principally used when selling a business to company executives or another company which wants to get into your line of business.

- *Liquidation value:* This value assumes liquidation of the company's assets and payment of all liabilities. It is used to determine the *absolute* minimum value of the business.

- *Dividend value:* This method assumes the company pays out a certain percentage of its net income, say 50%. You then average the last three years' net income, say, $90,000, and divide the $45,000 dividend payout (50% times $90,000) by a desired annual return, e.g., 8%. That results in a value for the company of $562,500

($45,000 dividend payout divided by 0.08).

☐ *Capitalized earnings and cash flow:* This method applies a present value rate of about 15% to the company's projected net income to get *today's* value of that projected income stream. This value can then be adjusted to include depreciation and amortization expenses for a total *projected cash flow value.* Although more work to compute, this valuation method usually results in the highest value for a business. For more information on this valuation method, please see page 19.

More Valuation Considerations — please see the next page.

Summary of Valuation Methods

Valuation Method	Value	
Reported Net Book Value (NBV)	$400,000	
Tangible NBV	$350,000	
Adjusted Tangible NBV	$565,000	*
Price-Earning's Multiple Value	$672,000	
Multiple of Operating Profits	$936,000	

* When applying the book value methods, use this higher value of $565,000 since it includes the two values above it.

More Valuation Considerations

☐ *IRS Revenue Ruling:* There will be instances when the IRS may be reviewing your valuation (e.g., when valuing an estate or stock gifted to your children). Its overall requirement as outlined in Revenue Ruling 59-60 is: *Fair market value determined on an arm's-length basis...considering all relevant factors.* Be especially cautious of the IRS' fair market value requirement when transacting with family members. The value you establish will be reviewed closely, particularly in gifts and buy-sell agreements.

☐ *Recent stock sales and options:* If there are historical valuation transactions, which were negotiated on an arm's-length basis, these values can be included in your valuation or supply support to the final value. *Examples:* The former buy-out of a partner, the value set in a buy-sell agreement, the option price in a stock option plan for key executives, or the value used on past gift tax returns.

☐ *Use of valuation experts:* Courts are relying more and more on independent appraisals made by qualified valuation experts, particularly since they have the expertise to allocate a plus or minus value to the various valuation factors. Experience shows that the IRS and courts tend to accept such independent valuations over an owner's value. Before hiring an independent valuation expert, ask for references and talk to other owners who retained the individual or firm to prepare the valuation.

☐ *Per-share values:* To determine per-share values, divide the shares you own by the value of the business. For example, Marlow Electronics has 100,000 shares outstanding, of which James Milburne owns 25,000 (25%). Based on Marlow's $708,400 final, weighted value, Milburne's 25% share of the company is worth $177,100. His per-share value is $7.084 ($177,100 divided by 25,000 shares).

Different Values for Different Purposes

Remember, your answers will vary with the questions. What is the *value* of the company if I want to sell out or buy another business? How will outsiders *value* the company if I'm selling part or all of the business? How do I *value* stock options given to key executives? How will the IRS *value* the company on my death or when I gift or transfer ownership to my family or others? What is the *value* of my business as a going concern that provides me with income and valuable fringe benefits?

If you are selling the business, the asking price should be the highest value, i.e., the $936,000 value determined by the Multiple of Operating Profits Method on page 12. Get an even higher selling price by analyzing who's buying the company and determining the synergistic savings that would result from the combination of your company and the buyer's. If those savings are significant, adjust your operating profits upward and *then* apply the multiple.

Don't be timid when setting an overall price or value on the business, but do your homework. Adjust your company's financial statements to maximize the value and selling price, compute several valuation methods to support that higher price, and then "market" your company by conveying the strong aspects of the business and its potential for growth and profits. That's how business owners walk away from a closing with the most cash.

References:

- *Exhibit 1:* Valuing a Fast-Growing Company, please see page 19
- *Exhibit 2:* How to Adjust a Company's Financial Statements, page 20
- *E*xhibit 3: 14 Ways to Increase the Value of a Business, page 23
- *Exhibit 4:* Present Rates and Factors for $1.00, page 26

Exhibit 1

Valuing a Fast-Growing Company

Another way to value a company's stock is by projecting its earnings and then discounting those earnings to determine their value today. This capitalization of income method is used when a company's earnings are growing at an annual rate in excess of 15%. It usually yields the highest value for the business and is particularly appropriate for fast-growing companies.

For example, if Marlow Electronic's profit of $74,000 were to grow to $400,000 in five years, an annual growth rate of 41%, the company would be worth — in today's dollars — the present value of that income stream. That's determined by multiplying the earnings for each year (for the five-year period) by an appropriate discount or present value rate, usually the 15% we mentioned above.

To illustrate the concept, let's look at Marlow's projected earnings of $400,000 in five years. Using a 15% present value rate (.497 factor), $400,000 earnings obtained five years from today is worth only $198,800 today ($400,000 times .497). Put another way, $198,800 invested today at a compounded annual growth rate of 15% for five years will be worth $400,000 at the end of the five years.

Formula: If you want to apply the capitalization of income value to your business, do the following: (a) project your net income for five years and multiply each year's projected net income by a 15% present value rate (factor), and then total them; (b) take the fifth year's projected net income, divide it by 15%, and then multiply that figure by the fifth year's present value factor, and (c) add (a) and (b) for today's value of your company.

To help you prepare company projections using *different* present value rates, please see Exhibit 4 (page 26). □

Exhibit 2

How to Adjust Financial Statements For the Highest Value

The goal: To adjust the company's profits **upward** so you can apply the price-earning's and operating profit (EBIT) multiples to the higher profits for the **highest** value and selling price. Even if you're not in the market to value or sell the business today, the concepts and examples illustrated in this report are crucial in understanding how you will set a value and selling price in the future. They work in reverse also, to help you determine the best purchase price for a business you're interested in buying.

The process: Before starting the valuation, you must adjust the company's financial statements. That's especially critical for closely held businesses because owners of these businesses typically keep *reported* profits as low as possible to minimize taxes. Some of the techniques used to lower a company's taxable income and profits include increasing salaries, declaring bonuses, setting aside more retirement money, and writing off inventory.

Fact: On average, a company's *adjusted* profits will be 80% above its *reported* profits. Its *adjusted* stockholder's equity (net worth or net book value) is usually 40% to 60% above *reported* equity. So don't penalize yourself today or limit the value of the business just because you made salary, tax, and cash flow decisions which lowered the profits in the past and reduced your stockholder's equity account. In most cases, the impact of those decisions can be explained and illustrated to a potential buyer by showing them the adjustments you made to reflect the company's true profitability and equity position. And that should be done *before* starting the valuation or selling-out process.

Income Statement Adjustments

Adjustments to a company's earnings should **add back** to earnings: (a) excess compensation paid to the company's owners/officers and family members above reasonable amounts, (b) extraordinary tax writeoffs of bad debts, unusable inventory and equipment, etc., (c) unreasonably high fringe benefits, (d) special year-end

bonuses, (e) investments in affiliated businesses, and (f) any nonrecurring expenses incurred in one year which benefit the company over future years, e.g., preparing and printing sales brochures, new product development costs, establishing a new sales office, etc.

Example of add-backs: If the company's *reported* pretax income is $90,000 ($60,000 after taxes) and these adjustments total $70,000, its *adjusted* pretax income is $160,000. To this figure, apply an overall tax rate (say, 35% overall) to obtain the company's *adjusted* net income of $104,000 (65% times $160,000). Thus, the company's *reported* aftertax income was adjusted from $60,000 to $104,000. Now, to determine the value of the business, let's apply a simple 10 price-earning's multiple (p/e) to both numbers:

Reported Net Income: $60,000 x 10 p/e = $600,000
Adjusted Net Income: $104,000 x 10 p/e = $1,040,000
Added Company Value = $440,000

The added value of $440,000 represents a **73% increase** above the value based on the company's *unadjusted* financial statements. That shows you the importance of adjusting the financial statements *before* starting the valuation process and/or setting a price tag for selling the business.

Balance Sheet Adjustments

Do the same to the assets on the balance sheet, e.g., inventory, real property, leasehold improvements, equipment, and investments in affiliated companies. The reported net book values of those assets also are usually *under*stated and must be adjusted upward or downward to fair market or replacement value. The extra values are then added to the company's net worth or stockholder's equity account.

Example: Let's assume that on the company's latest balance sheet, your accountant reports that the company's net plant and equipment value (after accumulated depreciation) is $220,000. However, you do some research on current pricing and you find that the current fair market value (FMV) of the plant and equipment (if sold as is) is $300,000. Thus, you have an *increased value* of $80,000, which would be added to the company's stockholder's equity account, which correspondingly increases the overall value of the business.

What about the replacement value? This computation is also important since it

values the plant and equipment as if they had to be totally replaced today. With rising costs over the years, as well as depreciation of the assets each year, the replacement value should be substantially higher than the FMV since that value assumes the assets are sold today in their current used condition. Thus, using an assumed replacement value of $400,000 in our example above, the company's increased value is $180,000 ($400,000 replacement value *less* the accountant's reported net book value of $220,000). That $180,000 represents an 82% increase above the accountant's reported value of $220,000.

Who's interested in replacement values? Potential buyers of the company who want to get into its line of business *or* company-employed executives who want to buy the business from you. *Your selling position is:* It would cost them $400,000 to replace the equipment and get to where the company is today. Furthermore, the equipment is in place, de-bugged, and fully operational. Those are very strong arguments to use in valuing these assets above the accountant's reported net book value.

Final comments. *First,* if the company is a sole proprietorship, partnership, S corporation, or limited liability company, you must adjust the income statements as if it was a regular (C) corporation with applicable corporate, not personal, tax rates.

Second, if the company owns an affiliate, that affiliate must be valued separately. *Reason:* The value on the balance sheet is the company's net cost basis, which could be substantially lower than the affiliate's fair market value. Again, that *excess* value is added to the stockholder's equity account. □

Exhibit 3

14 Ways to Increase The Value of a Business

It's not all numbers. There are many factors which affect the level of the multiple you apply to a company's profits and thus the resulting value placed on the company. Knowing those factors will help you **increase** the p/e and EBIT multiples to be applied to the company's profits.

Example: If a company's net income is $100,000 and we apply a 10 p/e, the value of the business is $1 million. If we can increase that multiple to 13, the value **increases** to $1.3 million (30%). That's the goal when valuing and selling a business, and the factors below will help you accomplish that goal.

#**1.** *Growth rate:* The growth rate of the company's sales and profits in comparison with our national growth rate and, in particular, the growth rate of the industry the company is in. The higher the growth rate of the company and the industry in which it sells, the higher the p/e and EBIT multiple.

#**2.** *Operating profits:* The company's operating profit as a percent of sales and its comparison with industry standards. For example, if the company earns 12% on each dollar of sales and the industry average is 8%, the difference of 4 percentage points supports a much higher multiple.

#3. *Fundamentals:* The fundamentals of the company — good profits and return ratios, excellent management, good second-line management, solid balance sheet, adequate facilities for growth, etc.

#4. *Niche:* The company's special position in the industry, whether for products or services, geographic area covered, production efficiencies, distribution know-how, reputation, trade name, etc.

#**5.** *Multiple sales opportunities:* The company's products or services have multiple markets and end-users, providing an opportunity for growth within current markets and from future penetration into new markets, particularly foreign markets.

#**6.** *Proprietary products:* Proprietary nature of the products and services, e.g., compare a company which is solely a distributor of products versus a manufacturer which has proprietary products. The more proprietary the products and services, the higher the p/e and EBIT multiple to be applied to the company's profits.

#7. *Customer list:* The breadth of the customer base, i.e., good distribution versus a heavy reliance on a handful of major customers. Also important is the *average* number of years these customers have been buying from the company, e.g., one year versus five years.

#8. *Product mix and gross profit:* The greater the number of products the company sells, and the greater the gross profit (percentage return) on those products, e.g., 40% versus 20%, the better. The higher the return on sales, the greater the number of dollars that flow to profits and thus the greater the multiple that can be applied to those profits.

#9. *Replacement value of assets:* View the business from the eyes of a prospective buyer. How much money would it cost the buyer to replace the company's assets and operations and how long would it take the buyer to get to where you are today? Knowing this replacement cost data is **critical** to negotiating a good deal and getting a higher multiple (price) for the business.

#10. *Interim results:* If they reflect a good increase in sales and profits, e.g., the six months' results show a 30% increase in profits, you can *annualize* the results and apply the multiple to the higher profits.

#11. *Income projections:* The higher and more certain the projections, the higher the multiple you can apply to the company's profits.

#12. *Growth capacity:* The company's current working capital, facilities, and employee levels are adequate to meet its sales and profit projections for the next few years.

#**13.** *Same line of business:* When a buyer is rounding out a product line you already have or expanding to a geographic area you already cover, you should adjust your company's profits upward (costs lowered) to allow for the buyer's reduced costs of buying the company. These *synergistic* savings can include duplicate accounting fees, select administrative and sales expense, and lease/rental expenses if the buyer intends to consolidate your operations into his or her company's. In essence, you want to know the buyer's profit *after* acquiring your business so you can apply the multiple to the higher profits.

#**14.** *Intangible assets:* Many of these assets may have already been written off and have a *zero value* on the company's balance sheet. These intangible assets can include: long-term customer and supplier contracts, high-traffic location, favorable leases, trained employees, a solid long-term management team, growth in the company's backlog, special manufacturing processes, licenses, franchises, trademarks, patents, copyrights, and/or an exclusive territory or product rights.

***

By carefully analyzing all facets of the company, you should find more tangible and intangible assets which were previously written off or for which the cash was already expended. Again, these assets can add greatly to the value of the business and its selling price. □

Exhibit 4

Present Value Rates and Factors for $1

Year	8%	10%	12%	14%	15%	16%	18%	20%	22%	24%	26%	28%	30%
1	0.926	0.909	0.893	0.877	0.870	0.862	0.847	0.833	0.820	0.806	0.794	0.781	0.769
2	0.857	0.826	0.797	0.769	0.756	0.743	0.718	0.694	0.672	0.650	0.630	0.610	0.592
3	0.794	0.751	0.712	0.675	0.658	0.641	0.609	0.579	0.551	0.524	0.500	0.477	0.455
4	0.735	0.683	0.636	0.592	0.572	0.552	0.516	0.482	0.451	0.423	0.397	0.373	0.350
5	0.681	0.621	0.567	0.519	0.497	0.476	0.437	0.402	0.370	0.341	0.315	0.291	0.269
6	0.630	0.564	0.507	0.456	0.432	0.410	0.370	0.335	0.303	0.275	0.250	0.227	0.207
7	0.583	0.513	0.452	0.400	0.376	0.354	0.314	0.279	0.249	0.222	0.198	0.178	0.159
8	0.540	0.467	0.404	0.351	0.327	0.305	0.266	0.233	0.204	0.179	0.157	0.139	0.123
9	0.500	0.424	0.361	0.308	0.284	0.263	0.226	0.194	0.167	0.144	0.125	0.108	0.094
10	0.463	0.386	0.322	0.270	0.247	0.227	0.191	0.162	0.137	0.116	0.099	0.085	0.073

Axiom. The greater the risk or uncertainty of an investment, the higher the annual return wanted and thus the higher the present value used. *Example:* If attaining a company's projections involves substantial uncertainties and risks, you may want to use a present value rate of 20% to 30% on the projected income stream. In contrast, if you are more certain of the projections (thus, less risk), you can use a lower present value rate, e.g., 10% to 18%.

About *The Business Library*

This **Report** is part of *The Business Library*, an extensive collection of Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. *The Business Library* is produced by an editorial and research staff with an *average experience* of **30** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

The information in *The Business Library* has helped more than 300,000 business owners, executives, entrepreneurs, investors, and individuals manage their companies and finances better, using several million copies of our reports, manuals, advisories, books, seminar workbooks, and newsletters to guide them in their business and family planning.

www.yourbusinesslibrary.com

Copyright and Publishing Notice