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KEY CONSIDERATIONS REGARDING THE VALUATION OF "SMALL" BUSINESSES

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Introduction

A simple definition of "valuation" is the process of estimating the monetary or economic worth of an asset based on the consistent application of generally recognized and accepted valuation approaches and methods. When the asset in question is represented by an investment in a business, the definition of valuation is relevant regardless of the size of the subject business.

The U.S. Small Business Administration defines a small business by annual revenue (ranging from $1 million to over $40 million) and by employment (from 100 employees to over 1,500 employees). If an analyst is tasked with estimating the value of a business with annual revenues of less than $5 million, additional factors specific to the structure and operations of small businesses should be considered. The valuation of small businesses (e.g., neighborhood drugstores, specialized machine shops, auto repair shops, dry cleaners, paint and wallpaper stores, magazine distributors, car washes, and bakeries) often require the application of valuation methods that are somewhat distinct from those used to value large companies but adhere to the same valuation concepts.

Regardless of the company's size, however, an analyst typically follows the steps outlined in generally accepted appraisal practice, including guidance provided by Internal Revenue Service Revenue Ruling 59-60, to develop a reliable estimate of value.

The typical broad steps involved in valuing a company are often identified as follows:

- Understand the purpose of the business valuation
- Determine the basis (i.e., definition) of value and premise of value
- Gather relevant data
- Analyze the historical performance of the business
- Determine the outlook for the business
- Select valuation approaches/methods to use and apply those methods
- Develop relevant indications of value based on the approaches/methods applied
- Apply premiums or discounts, as appropriate, to achieve the level of value sought
- Weight the indications of value to develop a value conclusion

Although the general steps for valuing a business of any size are similar, it may be prudent for an analyst to consider additional, unique factors when valuing small businesses.

This discussion focuses on (1) selected distinctions between small and large businesses, (2) certain adjustments often required to “normalize” the reported financial results of a small business, and (3) common methods often used to value small businesses.

Distinctions Between Small and Large Businesses

There are numerous distinctions between small businesses and large businesses. This discussion will focus on certain distinctions that affect the valuation process.

One of the primary challenges an analyst faces when valuing a small business may be a lack of information or incomplete information. Though counterintuitive, it may be more difficult for an analyst to obtain information regarding a small business than a large business due to the fact that small businesses often invest fewer resources in operating infrastructure and reporting platforms. As a result, small businesses often rely on third-party data analysis and reporting services and are reluctant, or unable, to divulge company-specific information. Unlike the extensive, internal data analysis that is performed at larger businesses, many small-business owners rely on their gut feelings or specific indicators, rather than documented analysis, to guide their decision making.

Another distinction between small and large businesses is the structure and support of internal accounting. Some small business owners try to limit bookkeeping and tax compliance expenses. This may result in accountants, enrolled agents, and other financial professionals being required to prepare and analyze financial statements and tax returns for small businesses that are not supported by readily accessible or identifiable financial data. For instance, the individuals responsible for preparing a business’s corporate tax return may enter the data without regard for the source data’s integrity. In addition, a small business’s accounting staff may have limited oversight capabilities. When preparing an income tax return, accounting staff may not review a small company’s internal financial data with the same scrutiny as a larger company, potentially missing certain year-end accounting adjustments. It is uncommon for small businesses to have their financial statements reviewed or audited, and supplementary information reports (such as accounts receivable and payable aging reports and payroll reports) are often not generated.

In addition, small businesses are sometimes distinguished from large businesses based on their relatively stable revenue, simple cost structures, and cash-basis accounting. Occasionally, small-business owners combine their personal and business expenses, obscuring the true functional cost relationships of the company. This circumstance makes financial and ratio analysis difficult and less reliable.

AS A RESULT, SMALL BUSINESSES OFTEN RELY ON THIRD-PARTY DATA ANALYSIS AND REPORTING SERVICES AND ARE RELUCTANT, OR UNABLE, TO DIVULGE COMPANY-SPECIFIC INFORMATION

Numerous small businesses operate without formal business plans, financial projections, operating agreements, buy-sell agreements, and succession strategies because many small business owners view the time and money required to produce these documents as unnecessary. Small businesses may be more preoccupied with their immediate operations and less concerned with longer-term issues that they view as tangential. Moreover, many small businesses are susceptible to volatile change because of limited products or services, geographic reach, and customer bases. The loss of a significant customer or supplier can have an outsized negative effect on a small business due to customer and supplier concentration. Many small businesses are also highly susceptible to the effect of external factors, such as economic shifts, industry demand, and technological development.

A management team lacking depth is another characteristic that often distinguishes small businesses from large businesses. Typically, the training provided to managers of small businesses focuses on preparing them to perform specific company-related tasks. In contrast, the training provided to senior managers at large businesses tends to cover a broader range of topics and responsibilities. If key personnel at a small business depart, the loss can impede growth and create an expertise void that is very difficult to fill. Even though large businesses can be affected by succession issues, small businesses are frequently more affected due to the specialization of their staff and the challenges associated with replacing staff.

The following section discusses some of the general issues associated with normalization adjustments often incorporated in the valuation process. Such adjustments are made in order to remove the effect of nonrecurring or unusual revenue and expense items from the reported historical operating results of the subject business in order to develop a reasonable expectation of future operating results achievable in normal operating circumstances. Certain normalization adjustments are typical when valuing small businesses.

Normalization Adjustments

Adjusting a business's historical operating results is a regular step in many valuations but is particularly common in the valuation of small businesses.

The standard procedure in valuing a business is to adjust its historical operating results, if necessary, to reflect the business's true prospective economic operating potential. Normalization, as this procedure is known, serves multiple purposes. Normalizing the business's results allows for a more accurate comparison with industry averages and guideline companies. Determining a business's ongoing earning capacity is an important step in the valuation process, and normalizing a business's earnings can provide a more accurate representation of the business's earning capacity.

Financial statement normalization is performed for a variety of reasons. Normalized financial statements more accurately reflect a business's recurring expenses, revenue, and cash flow during a period. When adjusting a business's reported historical operating results, certain discretionary costs and unusual gains or losses may need to be eliminated.

The following are examples of typical normalization adjustment focus areas:

- Unusual gains/losses on the sale of assets
- Inventory accounting methods
- Depreciation/Depletion methods
- Treatment of intangible assets
- Timing and recognition of revenues and expenses
- Treatment of interests in affiliates or related party entities
- Deferred maintenance
- Net operating loss carryforwards
- Prior period adjustments (e.g., accounting policies)
- Sales of actual or contingent liabilities
- Nonrecurring gains or losses (e.g., business interruption costs; litigation costs, payments, or recoveries; gain/loss on the sale of business assets; discounted continued operations)

Two normalization adjustments typically considered in valuing small businesses are (1) compensation related to the company's owners or officers, including discretionary expenses that benefit the owner or other family members, and (2) rent paid to related parties.

Compensation paid to the owner(s) of a small business typically is discretionary. Additionally, and based on the tax structure of a small business, compensation paid to the owner(s) can be significant or insignificant (relative to the revenue of the business). As a result, an analyst typically is required to consider how business owners determine compensation.

THE LOSS CAN IMPEDE GROWTH AND CREATE AN EXPERTISE VOID THAT IS VERY DIFFICULT TO FILL

For instance, it is common for business owners to reimburse themselves from company funds for personal expenses. Such expenses can include costs relating to automobiles, cellphones, insurance, and travel and entertainment. Often, a primary operating objective of a business owner is to minimize his or her tax liability. As a result, the owner may take compensation at levels above or below the market-based industry average or deduct personal expenses as business expenses.

For valuation purposes, an analyst often assumes that a hypothetical buyer of a small business would need to pay an individual to assume the current owner's operational responsibilities. This individual's market-based compensation would need to be commensurate with the individual's level of responsibility.

In other words, reported, historical compensation is replaced with market-based compensation. Similarly, an analyst would add back to reported operating results any discretionary (i.e., nonbusiness) expenses reported by the business owner(s).

Additionally, an analyst might examine whether any adjustments are necessary for personal credit card expenses paid by the business on behalf of the owner or other family members. This adjustment may already be factored into the owner's compensation estimation.

Another often material normalization adjustment an analyst may consider is the rent paid to related parties. When a business operates from real estate or real property owned by shareholders or a related party (e.g., family members or entities related by common ownership), the rent paid often is not based on market rates for comparable accommodations.

ANALYSIS CAN BE MORE INVESTIGATIVE IN NATURE AND MORE DEPENDENT ON CIRCUMSTANCE COMPARED TO ANALYZING LARGER BUSINESSES

If a business owns the property from which it operates, only costs directly associated with owning and operating the business-related property, such as insurance, property taxes, maintenance, and utility costs, should be expensed, along with the annual depreciation of the property.

If the business rents the property from a related party, market-based rental rates should be reflected in the operating cost structure of the subject business. In instances were nonoperating property is owned, an analyst would consider removing the reported expenses related to the nonoperating property and adding the market value of the nonbusiness (i.e., nonoperating) assets to the estimated operating value of the business. To facilitate this adjustment, an analyst may obtain a current real estate appraisal from a qualified appraiser to estimate the property's market value (and possibly to determine relevant rental rates based on market conditions).

When analyzing small businesses, the analysis can be more investigative in nature and more dependent on circumstance compared to analyzing larger businesses. As a result, an analyst may consider a variety of normalization adjustments.

When valuing a company, normalizing adjustments are essential since they enable the analyst to estimate the company's ongoing earnings capacity. As part of a due diligence interview with management, an analyst may request assistance identifying other potential areas for adjustment. After considering all potential normalization adjustments, an analyst is positioned to incorporate a reasonable expectation of the earnings capacity for the subject business into the relevant valuation methods to develop reliable indications of value. A thorough understanding of a company's normalized, ongoing earnings capacity enables an analyst to select the most appropriate valuation method(s) to employ when estimating value.

The following section focuses on various valuation approaches and the specific valuation methods an analyst can consider for the purpose of valuing a small business.

Valuation Approaches and Methods

Analysts typically consider three generally accepted business valuation approaches when estimating the value of any company. The generally accepted valuation approaches are the market, income, and asset-based approaches. However, the three approaches encompass a variety of methods that an analyst may consider when valuing companies. The most important consideration is to ensure that the final conclusion of value is supported by indications of value resulting from generally accepted valuation approaches and methods that are appropriately implemented and based on rational assumptions.

In any valuation, an analyst may employ one or more valuation approaches incorporating one or more valuation methods.

Common valuation methods typically used to value small businesses include:

- The public/private guideline company method
- The asset accumulation method
- The capitalization of cash flow method
- The seller's discretionary earnings ("SDE") method

Public/Private Guideline Company Method

The public/private guideline company method produces an indication of value based on consideration of the selling price of comparable assets, businesses, or shares of businesses that recently were sold or are in the process of being sold.

This method often is considered the easiest for an analyst to implement; however, obtaining comparable company data pertinent to the subject business can be time consuming and labor intensive and may not yield the desired (i.e., truly comparable) results.

WHEN SMALLER COMPANIES ARE INVOLVED IN MERGERS AND ACQUISITIONS, THERE IS OFTEN LIMITED PUBLICLY AVAILABLE HISTORICAL FINANCIAL INFORMATION AND PRICING DATA

For public companies to be used and deemed reasonably and reliably comparable companies, they must be reasonably comparable to the subject company in many respects. However, in practice, the pool of potential guideline public companies will have significant differences when compared to a subject small business, including differences in size, access to capital, geographical coverage, product diversification, and revenue sources.

When an analyst considers merged or acquired company transactions, it is possible that some transactions occurred during times with entirely different market conditions and, therefore, do not accurately represent the merger and acquisition environment that existed as of the relevant valuation date in a particular circumstance. Further, when smaller companies are involved in mergers and acquisitions, there is often limited publicly available historical financial information and pricing data. This limits the pool of transactions and guideline companies that an analyst can rely on when valuing a small business.

Asset Accumulation Method

Reasonable guideline companies and reliable indications of forward-looking income may not be available for some small businesses. In these circumstances,the asset-based approach may be preferred or even necessary.

The asset accumulation method produces an indication of value based on the difference between the value of the subject business's total assets and liabilities as of the valuation date. When employing this method, an analyst identifies the subject business's total assets and liabilities, or the analyst is provided with the subject business's balance sheet as of the valuation date. This resulting list of identified assets may contain tangible items, such as cash and accounts receivable, inventories, raw materials, machinery, and property; and intangible items, such as several types of intellectual property. Also included on the list are liabilities, such as accounts payable and accrued expenses, interest-bearing debt, and various other corporate obligations.

The analyst estimates the current market value of each asset and liability. The aggregate market value of the liabilities identified is subtracted from the aggregate market value of the assets identified to estimate the indicated value of the business equity. This method has two key conceptual issues.

The first conceptual issue is that the reported book value of a business's assets rarely corresponds to the market value of the assets. Reasons for this circumstance include: (1) accounts receivable that were written off because the customer did not pay on time but still can be collected, (2) inventory that management has deemed obsolete and written off but still has salable value, (3) businesses whose assets have been fully depreciated (i.e., with zero book value reported on financial statements) but still provide economic value, and (4) real estate that has appreciated over time but is still recorded for accounting purposes at its historical cost.

The second conceptual issue regarding the asset accumulation method relates to the fact that the method, when applied in a basic manner by many analysts, does not consider the business's ability to generate future profits as a going concern. This method produces an indication of value based on estimates of a business's asset and liability values as of the valuation date. When applied in a basic manner by many analysts, this method may understate the long-term benefits of a business's presumably efficiently organized and assembled asset base. Therefore, this measurement may be considered static.

Although there are methods within the asset-based approach that capture a business's intangible value and going-concern attributes, such as a capitalized excess earnings method or the adjusted net asset value method, many analysts do not apply these methods in the valuation of small businesses.

Capitalization of Cash Flow Method

The capitalization of cash flow method produces an indication of value based on dividing a normalized cash flow level for the subject business by a risk-adjusted capitalization rate (i.e., income multiple) derived from an assessment of relative investment risk. This method is relevant to all businesses, but particularly small businesses, because cash flow is the primary concern of business owners and potential investors. In addition, this method is most appropriate when a business's current or historical level of operating results is determined to represent a reasonable expectation of future operating results and when long-term growth is anticipated to be relatively stable.

SMALL BUSINESSES MAY FORGO HIRING HIGH-LEVEL EMPLOYEES, CHOOSING INSTEAD TO ALLOCATE RESOURCES TO OTHER PROJECTS

Notably, this method considers many risks associated with small businesses. One such risk is key person risk. Frequently, the success or failure of small businesses depends heavily on the abilities of their owners and managers. Some small businesses may forgo hiring high-level employees, choosing instead to allocate resources to other projects, such as the launch of new advertising campaigns, sales promotions, and other marketing strategies. When small businesses rely heavily on the performance of a single individual, that person's potential or actual departure can jeopardize a business's future by rendering future operating results highly uncertain. Such a circumstance may have a significant effect on the ultimate value of a business.

Seller's Discretionary Earnings Method

Analysts may also consider the SDE method when determining the value of a small business. SDE represents a measure of earnings and is one of the most widely used cash flow metrics considered when valuing small businesses.

An analyst starts with the subject business's normalized, expected operating earnings to calculate SDE. The analyst then adds back the owner's compensation and related benefits. Next, noncash items (e.g., depreciation and amortization) are added. The business's estimated level of SDE then is multiplied by a market-based pricing multiple derived from the analysis of sales of comparable businesses (whether public or private) to estimate the business's value.

SDE is an earnings measure frequently used during the sale of a small business; however, disagreements regarding the appropriate adjustments to include in the SDE calculation are common. This is particularly true when considering the owner's compensation or normalizing adjustments factored into the SDE calculation ultimately relied on to estimate an indication of value.

The SDE method often is referenced as a simple rule of thumb, incorporated in the valuation process as a sanity check to compare with indications of value that result from standard valuation approaches and methods.

The preceding examples are not intended to represent a comprehensive list of the various methods an analyst may consider when valuing small businesses.

Conclusion

This discussion identifies some key distinctions an analyst might consider when estimating the value of a small business versus a large business. An analyst should consider how certain small-business operational differences should be addressed in the valuation of a small business (e.g., relying on unaudited financial information or considering the risks associated with key persons).

An analyst may use normalization adjustments when analyzing a business's financial data to better understand and present the expected financial performance level of the business. Normalization adjustments are especially important in the valuation of a small business because the financial statements and other reported information relied on may be less scrutinized and refined compared to larger businesses.

Adjustments should be made to better reflect a company's true financial position and to distinguish which results truly reflect its operating capabilities. Several valuation approaches and methods are appropriate for the purpose of valuing small businesses.

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