Valuation

The Three Time Zones the Business Owner Must Explain

The valuator or appraiser is always looking to examine the fundamentals of a business when he/she reviews a business. Conversely, the business owner is always looking to push the valuator/appraiser to the future to see the "upside". The accepted techniques available to the valuator are income, market and cost and he/she must use these approaches carefully in looking at the past, present and future.

What I have learned over the last many years of undertaking valuations is that the business owner – if he really wants to impress the valuator - must take the initiative and the time to focus on the past, present and the future. Not to say that each must be weighted the same, but that each time zone should be considered. The reason remains simple – that is how a buyer/investor is likely to examine the company when he/she delves into it. Let's take a look at each time zone and see the factors that affect each zone.

First, is the past. To many parties, buyers and investors the past represents certainty and clarity as nothing can diminish the events of the past without a proper explanation. It is in this time zone that the owner should start to tell and reconstruct the story of his/her business. The likely story should be told that starts with how the firm got formed and the business developed. While this can be folklore the owner should be careful as its development history explains the very fabric and nature of the business. It also provides the valuator insights right away into the business strengths and weaknesses. The owner – at some point – should also provide his/her assessment of the last 3-5 years that provides an overview of how the business has operated in the last few years and what the key events and growth items have been. Remembering that the valuator is always wondering if the items are sustainable and do provide the company with real competitive advantages. Hence, the past provides valuable indications of worth and can't be discounted entirely most of the time. The valuator can use a capitalized earnings or cash flow approach as one means to often weight (by average or weighted average) the income/cash flows of a business by looking often only at its last "x" number of years of performance (i.e., past performance). The valuator can also use a "cost to reproduce" or "replacement cost" approach to consider the historical costs of development and/or to understand the historical built-in value. All of these noted methods/approaches are often used as means to understand the past. Of course, the valuator must also consider any historical transactions that have occurred through the history of the business. Owners often don't like disclosing the terms and conditions of equity acquisitions because they often believe they are not indicative of value; however, valuation theory holds one cannot simply ignore it. The

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responsibility lies with the business owner that he/she must framework and explain previous equity investments so as to delineate why or why not they should or should not be considered as an indication of fair market value – a situation that most owners do not deal well with this.

Second, is the present. Business owners like to always discuss what they are presently doing and how they are building the foundation or fundamentals of the business. Of course, the valuator is always looking at the current situation as a realistic indication of what the business fundamentals are. The business owner needs to explain how the present is better than where they were and why. Not all owners do a good job of that. Owners need to make sure that by outlining the past they need to show and demonstrate what has changed exactly to the present. This is critical because it shows the growth in business fundamentals and how the business has accomplished it. Owners need to make sure to indicate how they have done and what evidence exists they can do it again.

It is almost always apparent that business owners know their marketplace and that factors that affect it. However, far fewer owners can explain how they can better attack and penetrate the market with anything that is definitive and clear. Most owners spend endless time talking about how their level of service is far superior to their competitors as their key competitive weapon – failing to realize that 99.9% of all firms tend to believe that. If such statements of service differentiation are to be believed it often depends on the owner's ability to demonstrate specifically what service differences really exist and how they can maintain them. The valuator is also questioning this. Also, critical to the present, is the owners/managements abilities to demonstrate how the business financial results can be – at a minimum – maintained and how and why growth can occur.

Finally, there is the future. As Yoda always said, "Difficult to see; always in motion is the future." Never has a statement been more true. Owners always want to talk about the future and convince the valuator that the future is certain and that he/she always knows with 100% accuracy what the future will be. However, the reality is that the only thing we all know for sure is that our predictions will never be 100% accurate. Hence, we must deal with the fact that we all have to figure out a range of possibilities that make sense. On the one hand, the valuator always tries to figure out the low end of management's projections as well as the high end. The valuator rarely believes the owner's statement that "these projections are very conservative"; as if the owner would ever say "these projections are crazy". What the valuator is often trying to get comfort with is the revenue numbers. The reason for this is that most people can provide pretty good certainty on their cost structure, but not always their revenues expectations. The valuator will look towards a waterfall analysis of the revenues (an account/situation by account/situation breakdown) to provide the valuator a realistic sense of how much granularity the owner really can delineate to the valuator. Be prepared to do this if you want to have a valuator believe your projections to some level. Owners are typically looking at the valuator to undertake a discounted cash flow analysis of the free cash flow from future operations as a key indication of value. While this approach may or may not make sense, it is also important to note that the valuator often also looks at what level of cash insertion/investment is needed in order for the projections to be accomplished. Many times the owner fails to accept the fact that to get a snowball to roll down a hill some level of 'push' is required to get it to start rolling. The owner has to be prepared to explain this and also to convince the valuator the amount of capital (if any) that is needed.

As the valuator is preparing his work and report(s) he/she must now take pause to reflect on the past, present and future so as to provide certainty to what he/she calculates fair market value to be. It is likely reasonable that the valuator might consider taking a weighting of the past, present and future in calculating fair market value. In this manner, he/she might use a weighted valuation approach that would consider the past and a technique to account for it (e.g., depreciated replacement cost and adjusted book value method), the present and a technique to account for it (e.g., public market guidelines method), and the future and a technique to account for it (e.g., a discounted cash flow method). A question of judgement remains as to how much each approach should be weighted so as to fairly determine the value of the business and its assets. The task and challenge of such weighting remains with the valuator, but the ability of the business owner(s) and management to demonstrate and support the reasons as to what the weightings should be will go a long way to which weightings are applied by the valuator and which techniques are the most reasonable to use. Owners need to remember that buyers and investors always seek the past/present as the safe zone when calculating value and hence must provide real evidence as to why the future and other measures should be weighted more heavily.

The final valuation report remains the privy of the valuator. How he produces such a report always is influenced by the people and owner that control and manage the business. While personal goodwill cannot be included in business goodwill and determination of fair market value, the owner/management's ability to carry out the business plan is always a key factor that the valuator considers.

Owners and management need to see valuations from the outside parties' view as well as their own. This principal reason is that value is based around a willing seller and willing buyer – in other words both views need to be respected in order for a transaction/deal to occur. It is only when both parties can reach a deal is the argument that is the "highest price available". The above also indicates that the owner/management has to spend some real time and effort to work on the strategies that are always in question at the heart of the valuation as such work is a lot more than simply collecting information and reporting on a bunch of numbers.

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