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Know your value

"Ownership Succession and Valuation Implications"

In this article, we review various alternatives for transferring a business to the next generation of owners and look at how various valuation methods apply to each.

Ownership Succession Alternatives

In summary there are six broad alternatives for transferring the ownership of a business:

- Pass it to the kids (or other heirs). This can be accomplished by gifting shares of stock during your life, or transferring the business as part of your estate (preferably using estate planning to manage the tax impact).
- Sell it to the management team
- Sell it to the employees in an employee stock ownership plan (ESOP)
- Sell it to a third party
- Sell it to the world, as in go public in an initial public offering (IPO)
- Shut it down. Shutting down the business and liquidating the assets is not generally viewed as the optimal conclusion to business ownership, but sometimes this happens.

Pricing - High, Low, or Just Right?

Value is an opinion of what something is worth. ***Price*** is the amount at which a transaction occurs. As the business owner, are you seeking a price that is high, low, or just right? The price at which the transaction occurs may differ due to the structure that is put in place and the impact of that structure on value.

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When making gifts to family, a business owner may find that a lower value is more tax effective. As such, the type of interest gifted is often a minority block of stock or nonvoting stock. It is also typical for there to be contractual restrictions on the transfer of shares.

At the other end of the spectrum is a sale to an independent third party. In that case, the business owner usually wants to maximize price. The same holds true for IPOs. In the unlikely event of liquidation, the business owner usually wants to at least get the maximum amount that he can get out of the liquidation.

In the case of a sale to management, the business owner will want to get a good price, but he may also want to ensure that the management team can afford to service any debt incurred as part of the transaction (especially if the debt is owed to the seller). This is even more true for an ESOP. Planning for a new ESOP involves a feasibility study to ensure that the company can afford to service the ESOP debt and eventually honor the ESOP repurchase obligation.

Valuation Methods

For each of these ownership succession alternatives, there are multiple valuation methods that can be applied. These methods fall under three widely accepted approaches to determining the value of an asset such as a private business interest – the income approach, the market approach and the asset approach.

- **Income Approach.** The income approach is based on the premise that the value of an investment is a function of the income that will be generated by that asset over its expected life. In the ***discounted cash flow method***, the company's cash flows are projected for a number of years into the future and then discounted back to their present value. An alternative to this is the ***capitalized cash flow method***, which capitalizes a single normalized level of earnings, typically based on historical or pro forma results.

- **Market Approach.** The market approach examines actual sales of similar assets to estimate value. Both the public and private markets can provide evidence of the prices investors are willing to pay for businesses. In the guideline public company method, the primary source of information for the market approach is from the pricing multiples of publicly traded companies that are similar to the company. The merger and acquisition method looks at acquisitions of comparable companies and develops value multiples based on those transactions.

- **Asset Approach.** The asset approach determines value by examining the value of the company's assets and liabilities. This method is most relevant when valuing companies that have low profitability relative to their asset base. In the net asset value method, the market value of assets less the market value of liabilities typically results in the value of the company excluding any goodwill[1]. The liquidation method goes one step further, and assumes that the assets and liabilities will actually be liquidated and that the costs of liquidation will be incurred.

The various ownership succession techniques tend to be associated with the various valuation methods. Below are some examples (these are not absolute rules, just observations):

- Gifting and estate planning often involve minority or nonvoting interests. Conversely, the merger and acquisition method is based on change of control transactions. This is a very different level of value, so the merger and acquisition method is less applicable or needs to be reconciled to a minority level of ownership interest, typically through discounts for lack of control and lack of marketability.

- The merger and acquisition method is extremely applicable when evaluating the value of the company for a sale to a third party.

- When the capitalized cash flow method is used, it usually indicates that projections are not available or that no changes are expected in the company's performance. This method is often viewed as less sophisticated than the discounted cash flow method (although both methods are based on the same

[1] In some cases, the value of a company's equity can be less than its net asset value, but that is a topic for another day.

underlying model). For companies that are considering going public or implementing an ESOP, a more detailed analysis of future cash flows is appropriate. The cash flow projections used in the discounted cash flow method are also useful for evaluating the ability of the company to service debt in a leveraged management buy-out or a leveraged ESOP.

- Asset liquidation is typically not the anticipated strategy when an IPO is contemplated. More typically, a large, growing enterprise is envisioned. The discounted cash flow and guideline public company methods tend to be used when evaluating an IPO.

It probably goes without saying that if liquidating the company is the decided-upon course of action, then the asset liquidation method is the appropriate analysis.

But it's all fair market value, right?

If an appraiser is asked to conduct a valuation of a company, would the value be different just because of the succession strategy? As discussed earlier, the various valuation methods tend to fit better with the various scenarios, but in theory, the valuation methods can often be reconciled. What drives the difference in value is not the methods being used, but the premise of the valuation and actual features of the stock under each successions strategy. For example:

- Will the block of stock have control over the company?
- Will the future performance of the company change as a result of the succession strategy?
- Will there be restrictions on the transfer of the stock?
- Will the stock have a put right?
- For low profit companies, is the assumption that the company will continue to operate or that the assets will be sold?
- Does the universe of hypothetical buyers of the stock include a significant number of strategic buyers?
- Will the seller continue to be involved in the business to support the transition?

Value is not affected by the ownership succession plan, but rather by the impact on the features of the company and the stock that are expected to result from the succession plan. A business owner considering his succession plan should put together a structure that meets both his personal goals and any objectives he has for the company. He should also be aware that the ownership succession can impact the value and price of the equity.

About the Author

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Nick is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers and has more than 20 years of experience in valuation, finance, and banking.

He serves on the Valuation Advisory Committee of The ESOP Association and is Co-chair of the Membership Committee of its Ohio/Kentucky Chapter. Nick has been a presenter on valuation topics for The ESOP Association, National Center for Employee Ownership (NCEO), Ohio Employee Ownership Center (OEOC), Southwest Ohio Tax Institute, the North Carolina Bar Association and Lorman Education Services. He has provided valuation training and judging for the Association for Corporate Growth's ACG Cup competition. Additionally, he has presented a full-day seminar on business valuation for the American Society of Appraisers.

Nick earned a Bachelor of Business Administration in Finance and Real Estate from the University of Cincinnati and an MBA from Xavier University.