Business Valuation

The basics on how to determine
what your business is worth.

Business Valuation: An Overview

When considering selling your firm to your employees, determining how much the firm they're going to buy will cost is of the utmost importance.

Often business owners founded the company and have put years of their life into growing the business, it is an emotional process. The unfortunate reality, is that most business owners don't have a good sense of what their business is worth and letting emotion drive the process can set the stage for a tense and confrontational negotiations. Especially when a founder is going to remain at the business after the conversion, it is critical that the principles that drive the best democratic management decisions are utilized – honesty, transparency, and communication.

There are three main methods used to value a business. This guide will walk you through the basics of how a firm's value is calculated and provides a checklist of the materials you will need to prepare to ensure your business' value is calculated properly.

Market Transaction Valuations

Income Based Valuations

Asset Based Valuations

Determining the value of a closely held company is a difficult and imprecise science. There are multiple methods, each with their own strengths and weaknesses. Given this, it is better to understand value within the broader context of what range of value can be reasonably estimated, and in particular for an employee buyout, what can the business afford to pay on an ongoing basis to buy the company over a reasonable time.

Types of Business Valuations

Market Transaction Valuations

The market transaction approach seeks to determine the value of a firm by analyzing the values of similar companies. Looking at mergers and acquisitions of companies that are of similar size and the same industry, you can determine what others in the market are willing to pay. In market based transactions, a multiple of earnings or cash flow is often used to determine the market value. In this way, a company's value might be calculated by multiplying their earnings before interest, taxes, depreciation and amortization (EBITDA) by an amount in proportion to similar firms. While this method benefits from being simple, often in small businesses, there are not good examples to compare to, therefore this method is difficult to justify in most small transactions.

Income Based Valuations

There are two types of income based approaches to valuation, both based on the idea that the best way to determine a firm's value is to determine how much cash it can produce in the future. These methods are used when the cash a firm earns is central to its business strategy, when the firm is profitable, and it is relatively easy to predict future growth. The two methods are the capitalization of cash flow method, and the discounted future cash flow method.

The key difference between the two methods is that the capitalization of cash flow method looks at the current annual cash flow for a firm, while the discounted future cash flow method is based off of future projections. In both cases, however, the valuation is trying to determine the current value of cash flows that will occur in the future.

Asset Based Valuations

Asset approaches to value are based on the idea that a firm's value is equal to the underlying value of the company's net assets – this is also referred to as book value. For a co-op member, their investment in the firm is calculated using the assets based valuation. In a situation where the employees are buying a firm, an asset based valuation would be used if the company owned assets of significant value, did not have an established earnings history, or if it consistently had negative earnings and the future value of its earnings is less than the value of its assets.

Other Valuation Factors

Marketability Discount

Stock in a closely held company can't be easily sold, and when something is difficult to sell, its market value is less. Often the share value of a closely held firm will be discounted by as much as 25% to 45% to account for this. However, the structure of a co-op or ESOP creates a market for these shares because the company has to buy them back when employees depart or retire. Therefore, the marketability discount in an employee owned firm is often less than in a similar conventional firm.

Control Premium

On the other hand, when a controlling interest in a company is being acquired, the value of the stock is increased. A buyer with a controlling interest (51%) potentially has significant influence. They can likely select directors and appoint management, set policy, and declare when dividends are to be paid. When workers acquire 50% or more of the company, it's appropriate for a control premium to be added to the company. Generally, the control premium ranges from 10% to 30%.

Preparing for Your Firm's Valuation

Once you've begun thinking about selling your company to the employees, you need to prepare the appropriate materials so an accurate feasibility assessment and valuation can be completed. It's not necessary to have all of this information ready before you start the process, but to complete a feasibility assessment, the following information is essential. Even if you're just beginning to think about the process, this checklist can come in handy to prepare your firm.

3 TO 5 YEARS OF FINANCIAL STATEMENTS AND TAX RETURNS

While audited statement are preferable, statements prepared by management also work. If you don't have financial statements completed, ICA can work with you to prepare them.

AN UP TO DATE BUSINESS PLAN AND OR MARKETING PLAN.

Accurate earnings projections are key to establishing the business value based on its income.

BUSINESS OPERATING PROCEDURES

The more detailed, the better. These make it easy to understand how the business works, who does what, and what skills are required. This is especially important when an owner is looking to retire or otherwise exit the company.

CUSTOMER LIST, VENDOR CONTRACTS, LEASES

It's important to be able to 'check under the hood' of the financial statements to ensure that the projections are realistic.

LEGAL PAPERWORK (INCORPORATION, BY-LAWS, ETC.)

You'll need to amend the articles of incorporation and by-laws, so it's important to know how things are structured and governed now.

A LIST OF KEY MANAGERS AND STAFF.

It's especially important to understand who will be taking a leadership role in the company going forward and which employees are going to become members.

Related ICA Resources

ICA has developed a series of best in class materials designed to help business owners interested in establishing a democratic firm work through the process and build a structure and culture designed to help you succeed. For copies of these and other materials visit our website at: www.ica-group.org.

Ensuring Your Legacy - Selling to Your Employees: Many business owners look to employee ownership as a way to cement their legacy, yet the process can be confusing and perceived as risky. This report walks owners through the process of converting to a democratic firm helps owners address whether this is the right thing for them.

A Comparison of Employee Ownership Models: This publication provides a basic overview of the key differences between worker cooperatives, ESOPs, and hybrid models. It walks through the details of the various forms to help business owners weigh the financial and tax impact of a sale.

Model By-Laws for a Worker Cooperative: This publication provides a comprehensive introduction to worker cooperatives and includes a compendium of model by-laws for stock corporations and LLCs. Also included are annotations to the by-laws, as well as multitude of sample legal forms.

Governance Systems for Worker Co-ops: Worker co-ops are built on a framework of democracy, but without an effective means to put this into place, it does worker very little good. This how-to guide walks you through establishing an effective mechanism to ensure you are creating a democratic culture that works with your business.

The Internal Capital Account System: Value in a worker co-ops is tracked using a system of internal capital accounts. This guide covers the basics of co-op finances, including the difference between capital shares and capital accounts, tax treatment, and how to deal with financial losses.

About the ICA Group

The ICA Group, the country's oldest national organization dedicated to the development of worker co-ops, was founded on the belief that all people should enjoy economic self-determination as a means to foster an environment where workers' livelihoods and the communities where they live are stable and secure. We strive to facilitate such a society by acting as a catalyst for groups working to ensure workers have a meaningful say in their own economic future and through the development of firms that put these ideals into practice.

The ICA Group