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# Valuations and the Issue of Terminal Value

Along with deciding to engage in business succession planning and finding a successor, it is necessary to value your business. A valuation is necessary whether the business is to be transferred either to an heir or third party. If the business is transferred to an heir, it is critical that the fair market value of the business be established in a well supported form. If the business is to be sold to a third party, a valuation will ensure maximum value will be received.

A business valuation is a report written by a qualified appraiser for purposes including business succession, estate and tax planning, litigation, buy-sell situations and many other purposes which blend into each other. Given that purposes behind business valuations differ, methodologies also differ. Some methods are imposed by the Internal Revenue Code, others by common law, some by contractual agreement, and others by industry standard. Following is a brief discussion of different valuation methodologies.

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## Market Approach

**Comparables Price**

The comparable price method operates under the assumption that there are other companies comparable to the business being valued that are either publicly held or privately held that recently sold. The IRS suggests that when using this method, at least three comparable companies should be used. Once the comparables have been found, the net income, cash flow, EBITDA, and the Price/Earnings ratio can be used to compute a benchmark value. Individual company values can then be weighted and an industry benchmark can then be established.

## Asset Approach

**Adjusted Book Value (Net Tangible Assets)**

This method, also referred to as the underlying asset value method, and is especially useful in valuing holding companies versus operating companies. Investment houses and real estate companies are examples of holding companies. This method is also useful for liquidation purposes because it provides the "adjusted" asset value which relates to the fair market value of assets. It is also useful in valuing capital intensive businesses that rely on their asset base to perform work and generate income. An excellent example of this is a construction company. The company's machinery is vital to their operations. This idea can be contrasted with a law practice whose income generating ability does not rest on physical assets of the firm but, rather, on personnel. The key to this method is to determine the fair market value of all useful assets versus the value as stated on the books of the company.

## Earnings Approaches

**Capitalization of Earnings**

The consensus among appraisers is that the capitalization of earning power is "the most important single factor in the valuation of most operating companies, such as manufacturers, merchandisers, and companies providing various services." At the end of the life of a company, the total worth of that company can be found in the ability it had to generate earnings. This method uses historical data to project future earnings. The method goes back through five years and projects the earnings potential into the future, using a growth rate, present value calculation, and expected earnings figures.

**Present Value of Future Income Stream (Leverage Cash Flow Debt Method)**

A variation of the capitalization of earnings method is referred to as the "Leveraged Debt Concept." This concept takes into consideration the fact that an outside party may leverage an acquisition of the current company and use all of the income to pay the interest on borrowed money. Currently the cash flow method is becoming more important in valuations as companies tend to "free cash", i.e. earnings before interest, taxes, depreciation, and amortization (EBITDA).

**Excess Earnings Capacity (Goodwill)**

This method is based on the theory that the value of a company is equal to the value of the net tangible assets plus the value of excess earnings (e.g.., goodwill, patents, trademarks, copyrights, etc.). Eight factors are typically considered when calculating goodwill: age of the company, employee turnover, the value of the suppliers and the products sold, market area, potential growth, inventory efficiency, company location, and banking relationships. Excess earnings attributable to intangible assets are the foundation of the value of goodwill. Once this calculation is made, the result is added to the adjusted asset value as identified alone in the Asset Approach.

*All privately held companies should establish valuation approaches to be used for determining their value. Once these approaches are selected, the company should update its value on a regular basis.*

**Net Income Residual Approach or Dividend Paying Capacity**

This method looks at the income that is left over for the stockholders as it relates to a company's return on investment. Effectively, it can be referred to as the ability of the company to pay dividends to the stockholders using income that is not needed to operate the business in the future. Dividends are based on earnings after taxes as they relate to investment (stockholder's equity) at the beginning of the year. Dividends represent the after-tax earnings that are distributed to the stockholder instead of being kept in retained earnings to help finance future projects. This is a key method to determining what an investor would pay for participating in the operations of a privately held company.

## The Issue of Terminal Value

In theory, purchasing a business is comparable to purchasing a corporate bond. When the bond is purchased, the corporation or governing entity pays the holder interest for the stated term of the bond usually in 6 month increments or so. At the end of the term of the bond, the holder is repaid the value of the bond.

A business, on the other hand, operates in much the same manner, or at least it should. Upon purchase of the business, the owner benefits from the activity of the business and either draws or is paid some kind of distribution or dividend (depending on the type of entity). Though obtained in a different manner, these payments are similar to the interest paid in a bond. Upon retirement, death or exiting the business, the business owner is entitled to the fair value of the business (similar to cash in value of the bond) including a terminal value. While it is not paid out automatically, the terminal value may be obtainable through sale of the company to the next person.

When valuing a business, two methods can be used to determine the value: 1) Capitalize the future income obtainable by the company beyond a regular capitalization period, or 2) Discount the current book value of the assets backwards to obtain a reasonable terminal value to be added to the earnings potential for the company.

Often, the terminal value, adds more than 50% to the value of a business. This is the same with corporate bonds. Often, if the value of a bond is broken down, the income stream is worth 25 – 40%, while the residual value is worth 60 - 75% of the bonds value. Once the initial value is added to the terminal value, the true value of the business is reflected in the result.

## Conclusion

Several methods of valuing a closely-held company have been presented in this section. Each method has its advantages and disadvantages. Furthermore, no single method provides the absolute value of a company. The courts, as well as the IRS, have determined that more than one method must be used to value a closely-held corporation. The appraiser should determine which methods will receive the greatest weights based upon the relative importance of each method to the overall success of the company. The type of company, the purchaser, and the reason the company is being valued are all important factors to be considered when determining the weights assigned to the various methods presented in this situation.

All privately held companies should establish valuation approaches to be used for determining their value. Once these approaches are selected, the company should update its value on a regular basis. In this fashion, this will be a guideline value to be used for buy-sell agreements, succession planning, estate planning, and a possible sale of the business.

Readers should address any questions they have regarding the development of the proper approaches of valuations to the professionals at the Center. The Center values businesses on a regular basis throughout the United States and covers over seventy different industries.