WELLS FARGO Wealth & Investment Management

Advice and Planning Update

What is your company worth?

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Key takeaways:

- Business value can be impacted by many internal and external factors.
- There are three main methods for measuring value, with the income approach being the most commonly used.
- Analyzing profitability, growth, and risk helps you objectively evaluate alternatives and their potential impact on your business.

What this may mean for you:

- Understanding the value of your business and the key factors that drive that value can be critical in helping you make strategic decisions about the business.

From assessing unsolicited offers to preparing for potential estate taxes, knowing the value of your business is essential. The answer to the valuation question plays a critical role in addressing strategic options that face all business owners. Therefore, it is important to examine the role of the business as a significant source of wealth in order to plan for the future.

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Business valuation: Art and science

It is important to explore your perceptions of the risk and value of what is likely your most important asset. One key method for mitigating inaccuracies is by obtaining an objective view on value. The fair market value of a company is defined as the price agreed to between a willing buyer and a willing seller, each having reasonable knowledge of all relevant facts and neither under any compulsion to act. In some situations, a higher investment value may be possible, where your company has additional strategic value that a specific buyer is willing to pay for. However, for a seller, this synergistic value is hard to determine without access to detailed internal information of that specific buyer.

Unlike a publicly traded corporation, we cannot simply look up the value of a private company on an exchange. Estimating the value of a closely held business is not an exact science. It relies on skill and judgement in evaluating the facts and using multiple approaches and methods most applicable to the situation.

There are several fundamental factors to consider as part of any business valuation. The nature of the business and its past performance can be a guide to its future. The condition of the general economy, the specific industry outlook, and the level of competition provide insight regarding future expectations. Changes in laws, regulations, or international trade may also influence a company's top and bottom lines. Within a company, nonbusiness-related assets will need to be valued separately from those essential to operations. Similarly, financials should be adjusted for nonoperating and nonrecurring expenses. Risks related to customer concentration, management depth, and lawsuits or environmental liabilities may detract from value. Restrictions on dividends or the sale of shares may also affect value. The valuation exercises mentioned below help lead to an estimate of value for the company as a whole. To determine value at the individual shareholder level for a private company, the impact of a lack of marketability, and potentially a lack of control, must also be considered.

Multiple ways to measure business value

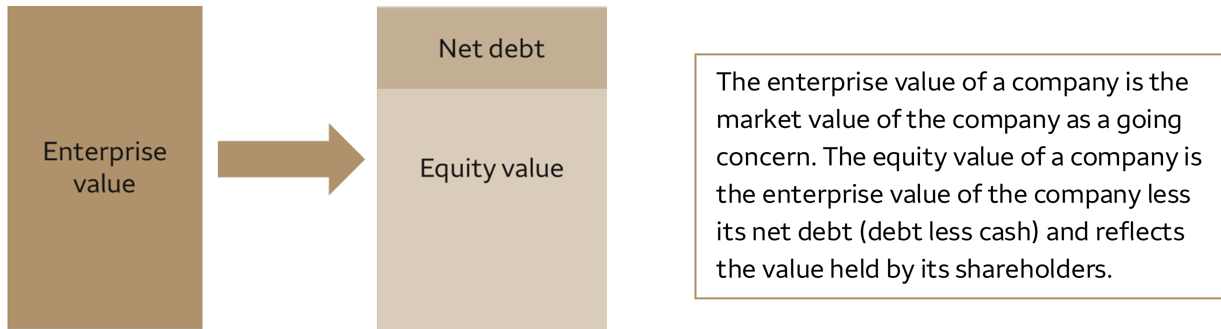
There are three main approaches to valuation: the adjusted net asset value approach, the market comparables approach, and the income approach. Ranges of value from each method can be presented based on variations of key underlying factors. Alternatively, the conclusions from multiple approaches may be assigned weighting factors and combined to arrive at an estimated fair market value for the company.

Adjusted net asset value approach. Investment holding companies and companies with large amounts of tangible assets, like land, equipment, or inventory, may rely more on the adjusted net asset value approach. This valuation is based on the marked-to-market value of a company's assets less its liabilities. However, this approach may not adequately capture the value of future growth, brand recognition, or other intangible assets.

Market comparables approach. If you are contemplating the sale of your company, you may find the market comparables approach more informative, as value is based on comparisons with publicly traded companies and similarities to prior transaction targets. Ratios of comparable companies' value to earnings, revenue, cash flow, or book value are applied to the subject company's own underlying numbers as a multiplier, creating an estimate for value. Enterprise value divided by earnings before interest, taxes, depreciation, and amortization, or EBITDA multiples, are a popular example of this method. Difficulties with this approach include finding comparable data and not properly factoring in company-specific growth.

Income approach. The most common approach for valuing an operating company is based on its ability to generate income. Essentially, the income approach asserts that a company's value is based on its stream of potential future cash flows. Positive cash flow represents the cash available after covering cash expenses, taxes, working capital increases, and capital expenditures. This remaining cash can be used to pay interest, pay back debt, or make distributions to the owners. Recognizing the time value of money, where a dollar today is worth more than a dollar in the future, cash flows can be projected for years into the future and then adjusted by applying a company-specific discount rate that ties in the risk of realizing the forecasted cash flows. These discounted amounts are added to estimate the current enterprise value of the company. After subtracting net debt, this amount

represents the estimated net present value to the owners of their equity in the company. Assessing risk and creating an accurate forecast are challenges to this approach.



The keys to unlocking value

The income approach reveals how value is closely tied to profitability, growth, and risk. A better understanding of these value drivers helps inform strategic business decisions and avoids generalizations driven by rules of thumb that may be inaccurate. Analyzing these drivers can help you and your advisors objectively evaluate alternatives involving the company. How sensitive is the company's value to assumptions around growth and margins? How can the Company reduce risk in its future performance and thereby increase its value? Will you achieve your financial goals by keeping or transitioning the business?

The owner can revisit the Company forecast regularly to account for changes in outlook, performance and tax policy. This becomes a great tool to help combat inherent biases, such as optimism around valuation or future cash flows and overconfidence in avoiding unexpected outcomes. It is also important to remember that external changes in the economy or your industry that are outside of your control may impact value just as much as, or even more than, changes in your operations. Purely focusing on your company's growth and margins may miss the impact of market timing and risk. Modeling various contingencies helps enhance understanding of risk in order to help develop more resilient wealth plans. Tackling the subject of valuation then opens the door to addressing the emotional factors tied to the business, such as family legacy and loyalty.

Conclusion

Having an understanding of the value of your business and the factors that drive that value is essential, as it can play a critical role in making strategic decisions when planning for the future. For more information on how your business impacts your wealth, reach out to your advisor at Wells Fargo.

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