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THE VALUE OF UNDERSTANDING BUSINESS VALUE

BY TOM BRONSON

"Business happens over years and years. Value is measured in the total upside of a business relationship, not by how much you squeezed out in any one deal."

Mark Cuban

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Any entrepreneur worth their salt knows their pricing model like the back of their hand and can provide details for each line of their P&L. But, can they do that very thing for their business value? The cost of misjudging their value has far-reaching implications. It outweighs all the careful attention applied to profit margins or EBITDA. Business Value needs to receive the same level of attention.

Only 17% of business owners successfully transition their business. That means 83% don't.

Wait, what?

Why?

Owners need to know what their business is worth today and understand what supports and drives that value. Too many times, owner confidence or apathy causes neglect and ignorance, creating an unrealistic expectation of the business's value.

Know the facts.
Get a valuation.

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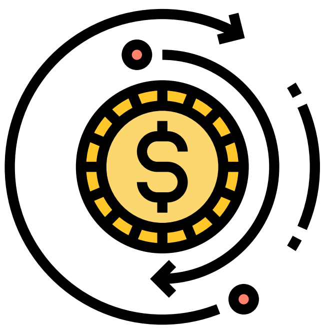
A valuation is a dose of reality for business owners. When business owners measure this data, they can motivate themselves and their employees toward value growth.

In most self-made businesses, the bulk of the owner's net worth is tied up in the value of the business. It is their retirement nest egg. Business owners need to determine a reasonable value well before exiting the business to keep this nest egg safe.

This form of retirement planning serves as a foundation for protecting and transferring wealth to the next generation.

A thorough valuation can provide the starting point for strategic value growth planning, giving It serves as an impactful tool to help identify and eliminate the various anchors to value growth.

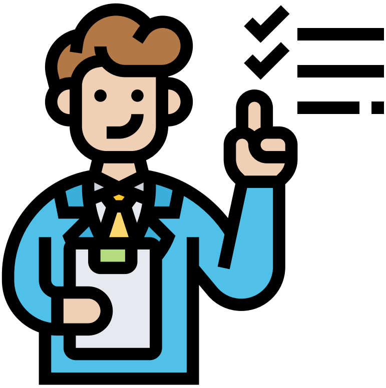


As part of a comprehensive business assessment, a valuation can lead to higher-value growth over time, which drives higher prices when the business eventually sells.

However, it's essential to understand that buyers can have different valuation methods, and the business may be more valuable to some buyers and less to others.

74%

OF BUSINESS OWNERS HAVE NO EXIT STRATEGY



DESIGN AN EXIT STRATEGY

Most business owners don't have an exit strategy, and that's a dangerous road to go down. Without an exit strategy, sellers can walk into a bad deal which will leave them feeling unfulfilled.

Exit strategy is just good business strategy.

There are roughly 6.1 million businesses that employ people in the US. Of those, about 93.9% are businesses that have $5M or less in annual revenue, which we call micro-businesses. Another 351,000 businesses, or 5.8%, have between $5M and $100M in revenue, which we call lower middle-middle market businesses. So, most businesses that employ people (99.7%) are small businesses. So, most businesses that employ people (99.7%) are small businesses and lower middle-market businesses.

BUSINESSES IN THE US

	SALES RANGE	# COMPANIES	PERCENT	REVENUE (TRILLIONS)	PERCENT
MICRO MARKET	Under $5M	5,678,000	93.9%	3.57	12%
LOWER MIDDLE MARKET	$5M to $100M	351	5.8%	5.84	20%
UPPER MIDDLE MARKET & ABOVE	Over $100M	21	0.3%	20.33	68%
TOTAL EMPLOYER FIRMS		6,050,000		29.74	
NON-EMPLOYER FIRMS		21,708,000		0.99	
ALL US FIRMS		27,758,000		30.73	

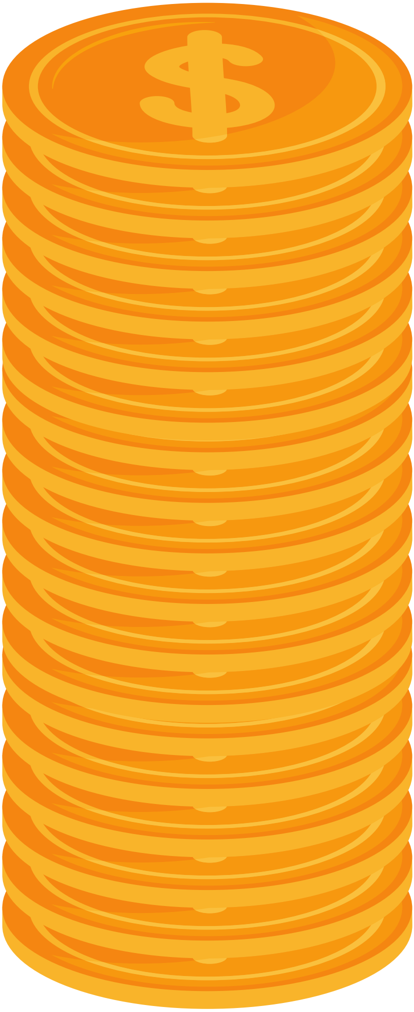
Corporate Value Metrics LLC 2013, Walking to Destiny, Christopher M. Snider 2016

Each year, about 250,000 businesses attempt to transition their business, whether by sale or other transition. But, here's where the challenge comes. Of the 250,000 that try to sell, only 17% (42,500) find a buyer and successfully transition the business. That is an 83% failure rate for businesses that come on the market each year. 83%. Let that sink in.

But it doesn’t have to be that way.

A good exit strategy identifies what you can do today to improve long-term sustainable value in your business. Planning early gives you time to take action. It gives you a runway. If you don’t plan early, it may be too late to take some of those actions that could have extracted better value for the business when it’s time to sell.

KNOW YOUR BUSINESS VALUE.

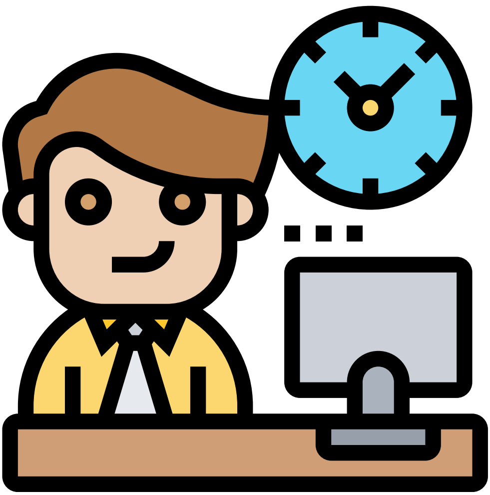


What you do today has tremendous implications on your business value down the road. One of the principles of value creation is that the more time you have, the more value you can create.

Do you know what aspects of your business create value or take value away?

Most business owners think it’s all about earnings. Indeed, that is a critical component of maximizing business value. But buyers typically look at EVERYTHING. The better prepared you are on the front end, the less likely the buyer will raise red flags later in the process. A “Red flag” is code for things buyers use to reduce or “retrade” their offer, and it chips away at your business value.

Sophisticated buyers won't believe short-term improvements in value. You'll need to have a solid track record, usually in the form of trailing twelve months (TTM), to demonstrate that what you've done is sustainable and not some short-term blip on the radar. In most cases, it will take several quarters, perhaps even a few years, until all the things you've done to build massive value finally make their way to your financial statements and valuation. Simply put...



IT JUST TAKES TIME!

So take the time **NOW** to determine what drivers impact your business value. A good place to start is our recent blog on Value Creation Revenue or VCR. You can check it out **here**.

POSSIBLE SCENARIOS

Here are a few examples of scenarios that can happen by not having a current business valuation, exit strategy, or understanding of value creation with far-reaching damaging implications to companies and shareholders.

- **EXAMPLE 1**

Three shareholders pour their blood, sweat, tears into a new business for years. A buyer comes in and offers $2 million for a 51% stake in the company. Happy dance! It was worth it. Finally, a way to take some chips off the table, right? Well, maybe...

Is that a fair price to hand over control of the company? During the startup and growth phases of the business, two shareholders loaned the business $1 million – is that reflected in the price?

In essence, a $2M offer for 51% values the company at roughly $4M. Netting out the $1M loaned from shareholders, the value to the shareholders is now $3M. But, if that $2M is used to pay off the $1M loan, then the net value to each shareholder is 1/3 of the remaining $1M for control of the company. Suddenly, it doesn't appear to be such a great deal.

If the business owners had been diligent about obtaining and updating a valuation, their negotiating position would improve dramatically - and they would be on the same page regarding the value of the business.

But wait, can't the sellers negotiate the price?

Negotiations are complex, even during the best of times. The best way to navigate offers of any kind is to understand your business value, its drivers, and the balance sheet structure.

That is the path to that elusive 17%.

- **EXAMPLE 2**

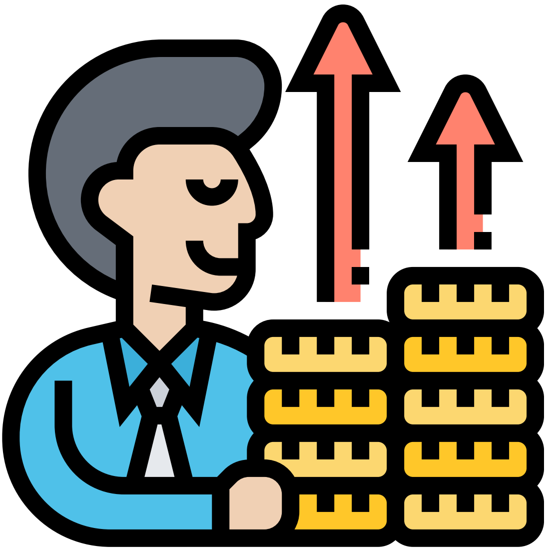
Five shareholders hold equal shares in a company. The valuation they did five years ago valued the business at $5 million ($1 million per shareholder). The owners got insurance as part of a buy-sell arrangement. Two of the shareholders tragically pass away in a car accident. The other three shareholders are now in a position where they need to buy the deceased's shares according to their buy-sell agreement. Unfortunately, that agreement hasn't been updated for five years. The company value is now closer to $50 million ($10 million per shareholder), but the insurance pays out only $5 million.

With $5 million in hand, but two $10 million shareholders to buy out, the remaining shareholders now must scramble to find another $15 million to buy out the shares. Otherwise, an unknown external buyer could purchase the shares at a discount and own 40% of the business... in addition to losing two key people.

Reviewing business value and updating plans and policies annually can prevent this risk to business owners. It is simple to do and limits business owners' exposure.

- **EXAMPLE 3**

Raising capital can be an intense exercise. The negotiations are challenging, and investors will hold the business owners accountable if reality strays from the picture you painted. Overconfidence leads to raising capital on promises of a return that is simply not sustainable.



Underselling your business leads to raising expensive funds. Future investors don't like this and avoid this like the plague. Understanding business value allows business owners to present a realistic and sustainable picture to bankers and investors. It puts you in the best position to succeed.

- EXAMPLE 3

Even if you’re not looking to sell your business soon, making improvements to your business now not only improves the value of your asset, it’s also solid business practice.

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It’s crucial to execute early to have a solid track record when you ultimately decide to start the process of selling the business. Buyers aren’t interested in paying for unproven “futures” - they are only interested in what you’ve already achieved, so it’s imperative to have a demonstrable track record.

Is there a formula to value businesses like mine?

Unfortunately, there is not a formula to predict a business’s value accurately. The ultimate way to value a small business is to have a willing buyer and seller agree on a price. Each business is different and should be valued based on many parameters.

As with anything, luck only gets you so far; you need a plan. The cost of inaction - or COI - may mean you end up rushing to close or sell your business and get less than you put into your business back. That is not good and not fair, but it is the reality for most business owners.

Take the time to get a comprehensive assessment and valuation, develop a succession plan or an exit plan and understand your key value drivers.

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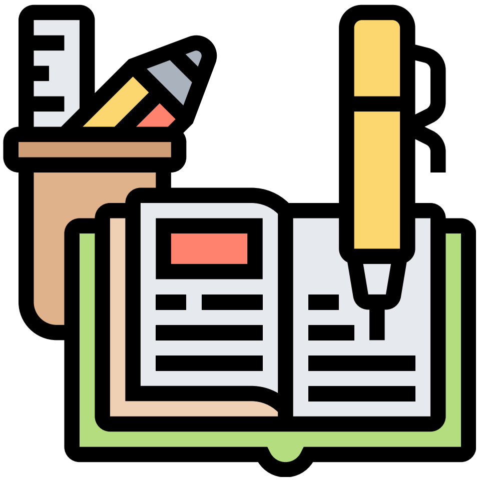

Advanced planning is the key to success for any business owner.

At Mastery Partners, we have developed a tool over the past 30 years through over 100 transactions. Our simple-to-use tool is called the Transition Readiness Assessment (TRA). It unmasks the value of your business and teaches you to maximize your business value so you can enjoy your business again.

Get more information at masterypartners.com.

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WHAT YOU DO TODAY HAS TREMENDOUS IMPLICATIONS ON YOUR BUSINESS VALUE DOWN THE ROAD.

WRITTEN BY

TOM BRONSON

Join our 5 Day TRA Value Challenge to find out more about value and our Transition Readiness Assessment. The challenge will give you a glimpse of how the TRA works and include a mini-assessment, which is a small sampling of the over 500 questions that make up the TRA.

Once you are on this path, we know you will also be a member of the 17% club - a business owner that successfully transitions their business on their own terms.

17% CLUB MEMBER
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