



Financial Advisory Services

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What's Your Business Worth?

Whether you're thinking of transitioning your business in the future or taking your last breath behind the CEO desk, every business owner needs or wants to know the value of the business they have so diligently struggled to create.

If you've never had your business valued, you probably have only a vague notion of what goes into the calculation. If you want to enhance the value of your business, perhaps knowing **how** your business is valued will enable you to improve on some of the elements that make up that value.

In the next few pages we describe the valuation process. See what makes your business tick.

OVERVIEW OF THE VALUATION PROCESS

HISTORY AND DESCRIPTION OF THE BUSINESS

A thorough review of the history and nature of the business is important for several reasons. It provides the appraiser with knowledge of the drivers of business longevity and the associated risks that affect value such as:

- If the business has a well-defined niche market or if it is a regional or national player.

- The operating model of the business.
- Who the key managers and employees are, which raises questions such as:
 - *What is the likelihood of success if these key people would depart?*
 - *Would there be significant costs in retaining these people?*
 - *When do key managers expect to retire?*
- How is the ownership structured?
- Is there a majority or sole control by one owner?
- Are there several large ownership blocks that control?
- Is there fractionalized ownership?

ECONOMIC AND INDUSTRY ANALYSIS

The appraiser should review the strength and direction of the overall economy, and take into account its impact on the business. Also of importance is the performance of an analysis of the industry in which the business operates. This analysis will identify historical trends, future expectations and their impact on business performance.

Inside:

- History and description of the business
- Economic and industry analysis
- Historical financial review and analysis
- The three approaches to value
- Additional considerations
- Conclusion



The Commerce Trust Company
A division of Commerce Bank, N.A.

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HISTORICAL FINANCIAL REVIEW AND ANALYSIS

An analysis of historical financial data is completed in order to assess the business's financial condition from both a balance sheet and income statement perspective. Key financial ratios are calculated. Areas for ratio analysis would at a minimum include: growth, leverage, profitability, turnover and liquidity. When this financial analysis is compared to industry norms such as a group of publicly traded companies, it allows the appraiser to observe the economic condition and performance of the business as compared to the guideline public companies.

After consolidating and analyzing this information, the appraiser then uses the information to calculate the value of the business using all or any of the following three methods.

THE THREE APPROACHES TO VALUE

In the valuation/appraisal profession there are three primary methods of determining value: the (1) Market, (2) Cost, and (3) Income approaches.

(1) The *Market Approach* measures the value of a company through an analysis of recent sales or offerings of similar companies. The financial condition and operating performance of the company being appraised is compared to the condition and performance of publicly traded and private companies operating in the same or similar industry, and potentially subject to similar economic, environmental and political factors.

The price at which the stock of a publicly traded company sells will represent the value of a minority interest in the company being appraised. The price of a similar private company will generally represent the total or controlling value of the company being appraised. Adjustments in value will thus have to be made depending upon the purpose for the valuation.

(2) The *Cost Approach* measures the value of a company by the cost to reconstruct or replace it with a similar company. Value is based on the net aggregate fair market value of the entity's underlying assets. The balance sheet of the company is revised substituting the fair market value of its assets and liabilities for their book values.

(3) The *Income Approach* measures the value of a company by analyzing the present value of

its future or historical cash flows. Valuation is developed by discounting expected future cash flows to their present value. The discount rate selected is generally based on rates of return available from alternative investments of similar type, quality and risk. Basically, what rate of return would a person who invested in this kind of business expect to realize when taking into account these three factors: (1) the rate of return you could expect from an investment with little or no risk (e.g., government bond); (2) an additional rate for inflation; and (3) a premium commensurate with the riskiness of this particular business venture.

If a historical cash flow approach is used, the discount rate is converted to a capitalization rate. Like the discount rate, the capitalization rate reflects the rate of return required to take on the operation of a business with this particular risk. The capitalization rate is then used to convert the historical cash flows to a current value.

The *Cost Approach* is frequently used in valuing holding companies or capital-intensive firms. It is not necessarily an appropriate valuation approach for companies having significant intangible value. The *Income Approach* is frequently used for entities with historically stable or predictable future income streams. Companies with volatile historical earnings or those fraught with uncertainty of future income predictability are not good candidates for this approach. The *Market Approach* can be applied to nearly any company as long as there are comparable companies subject to similar external factors as the company being valued.

ADDITIONAL CONSIDERATIONS

Further adjustments may be appropriate to determine the applicable discount for lack of control and lack of marketability associated with the business interest being appraised.

The owner of a controlling interest in a business enjoys some very valuable rights that a minority interest holder doesn't. In the event that control is an issue in the valuation, the analyst will need to assess the extent to which the various elements of control exist or do not exist in a particular situation and consider the impact of each element on the value of control. Sometimes a minority interest holder is not completely without all elements of control. For example, a minority interest holder could be in a position to cast a crucial swing vote, and to some degree influencing significant company actions.



A stock represents an ownership interest in a company and is more valuable if readily marketable. Conversely, lack of marketability detracts from the stock's value as compared to a security that is identical but marketable. In other words, the market pays a premium for liquidity or exacts a discount for the lack of it.

Ownership interests in closely held businesses do not, by definition, enjoy the ready market of a publicly traded stock. Therefore, a share in a privately held company is usually worth less than an otherwise comparable share in a publicly held company. Many factors affect the relative marketability of different business interests. Sometimes size of the interest is a factor. For example, a smaller block may be easier to market than a larger block, and in other cases the reverse is true. In most cases, the lack of marketability impacts minority interests severely. However, even controlling interests in closely held businesses obviously are not as readily marketable as shares of publicly traded stock.

CONCLUSION

After the relevant factors have been assessed, they must be brought together to arrive at a reasonable conclusion of value. At times, a single approach may appear to provide the most appropriate answer to the question of value, but the opposite may be true. Even within the same valuation approach, different methods will typically result in different indications of value. At this point in the process, it is up to the appraiser to weigh the results in light of the information and methods employed in order to arrive at an appropriate conclusion. Some of the factors considered are:

1. The purpose and objective of the appraisal
2. The quantity and quality of available data for the subject company
3. The degree of access to available data for the subject company
4. The supply of industry transactional data or comparability of publicly traded companies
5. The type of business, nature of business assets, and type of industry subject to appraisal

6. The number of shares and rights associated with the stock or business interest subject to appraisal
7. Statutory, judicial, and administrative considerations
8. The informational needs of the client for whom the appraisal is being prepared
9. The professional judgment and expertise of the appraiser

Ultimately, the final value estimate is based on the accumulated evidence as analyzed and assessed by the reasoned professional judgment of the appraiser.

The Commerce Trust Company can provide you with a professional valuation for your closely held business. Contact your Commerce Trust representative.

This newsletter is one of a series of informative documents that will help you to make decisions with respect to your business, its future and the future of your family and your family's financial well-being. Stay tuned for more reports to help you with your difficult decisions as a business owner. 🌐



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For more information on this or on other topics
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