NERI VAL™ Business Valuations
Eric Togneri
(678) 764-1732
eric@nericap.com
www.whatismybizworth.com

The "Heart" of the Valuation Report: Four Estimates of Value

By Scott Gabehart, Chief Valuation Officer (BA,MIM,CBA,CVA,BCA)

The "heart" of the valuation report is the four distinct estimates of value that are provided to the user. Different situations require knowledge of different types of value and the BizEquity algorithm has been constructed to be able to produce the most important types of value including the asset sale value and the equity value.

Both enterprise value and liquidation value are also relevant in select circumstances, but ***understanding the difference between an asset sale value and an equity value is key to effectively interpreting and utilizing estimates of value.***

Asset Sale versus Equity Sale

When valuing the entire company (100% control interest), it is typically **necessary to distinguish between the value of "assets" (asset sale) and the value of "equity" (stock sale).** In practice, owner-operated businesses are either sold on an "asset sale basis" or on a "stock sale" basis with the purchase agreement reflecting the unique aspects of each scenario.

A variety of factors will determine the chosen mode of sale, with buyer and seller negotiating price and an array of other "terms and conditions" including the type of sale. **Other "value types" exist such as enterprise value and liquidation value, but it is the asset sale and equity sale framework which accompanies actual business transactions.**

The **majority of smaller, owner-operated private firms are sold as asset sales while the majority of middle-market transactions involve the sale of equity.** The "asset sale" value will always differ from the "stock sale" value due to the specific group of assets and liabilities that are included or excluded in each format.

Business brokers and owners most commonly value businesses under the "asset sale" scenario through multiples of discretionary earnings while **valuations for divorce or estate taxes or a middle-market merger** will typically be based on the "equity sale" scenario.

In general, the goals of the buyer and seller are typically at odds with respect to the choice of deal structure. The rationale for selecting one over the other is complex and worthy of legal and tax advice.

The **seller typically prefers a "stock sale"** due to application of capital gains tax (sale price versus current "basis" in stock) rather than combination of capital gains and higher ordinary income tax rates. The **buyer typically prefers an "asset sale"** due to the avoidance of liabilities (known and unknown) and the ability to re-depreciate the fixed assets based on the "allocation of purchase price" per IRS Form 8594.

In some cases, l**icenses, contracts, or other key rights that belong to the corporation and cannot be easily transferred will dictate the use of a stock sale** so that key rights remain with the new owner. For example, a corporation with a hard to obtain FDA license would likely be structured as a stock sale so that the FDA license is maintained by the corporation and transferred to the new owner(s).

The general differences between the asset and equity transaction structure are summarized next.

Asset Sale Value

Includes ONLY inventory/supplies, fixed assets (furniture, fixtures and equipment) and all intangible assets (goodwill, customer base, tradename, covenant not to compete, etc.). Excludes all liquid financial assets and all liabilities. Buyer operates from newly formed legal entity.

It is calculated as a "multiple" of discretionary earnings or of revenues, e.g. 3 times discretionary earnings and is equal to:

<u>Asset Sale Value</u>

Value of Inventory PLUS Value of F,F&E PLUS Value of Intangibles

Equity Sale Value

Includes the assets listed above PLUS liquid financial assets LESS all liabilities (ST/LT). Involves the full transfer of the legal entity including current tax attributes. Buyer operates business from historical legal entity.

Remember that the value of the firm's "equity" is the key value perspective when dealing with shareholder/partner/member transactions. A "buy-sell agreement" among shareholders should revolve around the equity value due to each owner's interest in ALL of the firm's assets and ALL of its liabilities. Business valuations for purposes of gifting or estate tax planning should also be based on the equity value.

Using a Home Investment to Clarify Differences

Understanding the difference between the "asset sale value" and the "equity sale value" is a critical skill when discussing the report with clients. A practical example involving home ownership can shed light on the key differences. As a homeowner, there are two different types of "value" attributed to the ownership interest. The "asset sale value" would be what the home could be sold for on the open market, e.g. $1 million. The "equity sale value" would be the difference between what the home could be sold for and what the current mortgage balance is, e.g. $500K. The asset sale value is $1m and the equity sale value is only $500K due to the presence of the liability (mortgage debt).

A business is a bit more complex in that the asset sale value must also account for the "other" assets not included in the base definition of the asset value. Specifically, the equity value is equal to:

<u>Equity Value</u>

Asset Sale Value PLUS Liquid Financial Assets LESS Liabilities

Enterprise Value

In middle-market transactions, it is also helpful to distinguish between equity value and enterprise value. Enterprise value is a reflection of the firm's value as a functioning entity and it is helpful in that it facilitates the comparison of companies with varying levels of debt.

The enterprise value can be calculated directly as a multiple of EBITDA, e.g. 5 times EBITDA. In theory, enterprise value represents the value of the entire enterprise (not just the equity) or the entire "capital structure" (debt plus equity).

In practice, it is equal to:

Enterprise Value

Equity Value PLUS Long Term Debt LESS Cash

Liquidation Value

This value perspective is most relevant in the case of insolvency (liabilities exceed assets) or bankruptcy (unable to meet ongoing financial obligations). Insolvency and bankruptcy typically occur after one or more periods of accounting or taxable losses and the inability to generate cash flow from day to day operations.

It is generally equal to:

Liquidation Value

FMV of Identifiable Tangible Assets LESS Total Liabilities (ST and LT)

Liquidation value can be determined either on a "forced" or a "planned" basis, with the latter leading to a higher net value due to ability to identify willing and able buyers for company assets. The Bizequity liquidation value is closer to a "forced" liquidation value.

Which Business Value Conclusion is Most Important?

The answer to this question depends chiefly upon the purpose for the valuation engagement. If you are negotiating the sale/purchase of a business via an asset sale, then it is the asset value which is most relevant. If you are filing an estate/gift tax return, it is the equity value which is most important. When evaluating middle-market companies for M&A purposes, both equity and enterprise value will be useful. If your business is rapidly deteriorating and you are contemplating a reorganization, then liquidation value may be of most relevance.