

Key Family Wealth - Business Advisory Services (BAS)

Value Now, Grow Later: The Importance of an Early Business Valuation



Selling your business may not be on your immediate radar. But in today's volatile business landscape, it's essential to understand the true value of your business. Whether through a formal valuation or less rigorous methods, gaining such an estimate can serve as a cornerstone for informed decision-making, strategic growth, and a smooth transition when the time to transfer eventually arrives.

Let's look at how knowing the estimated value of your business might play out through the fictitious example of Sweet Success, a family-owned bakery.

Sweet Success was founded by Maria Garcia in 2005 and has grown to three shops. Maria's daughter, Sofia, joined the company 10 years later, bringing fresh ideas and a passion for expanding the company's online presence.

Maria wasn't considering selling her business as she approached retirement age. Nevertheless, she realized she needed a clear approximation of the bakery's value to plan for a smooth ownership transition to her daughter. In this case, an estimate suited Maria's needs better than a formal valuation, which would have been unnecessarily detailed and more costly.

The Garcias hired a local appraiser who specialized in evaluating small businesses. To determine the approximate worth of Sweet Success, the appraiser considered the bakery's financial performance, market conditions, and brand reputation. He also factored in the value of its tangible assets (equipment, inventory) and intangible assets (recipes, customer relationships).

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The estimate revealed that Sweet Success's value was in the range of \$3.5 million to \$4.5 million. That assessment was crucial for Sweet Success because it:

- **Provided a fair basis** for Maria to transfer ownership to Sofia, either through a sale or a gifting strategy.
- **Gave Maria confidence** about her retirement plans and financial security.
- **Emphasized the bakery's strengths** and areas for improvement, helping Sofia develop a strategic plan to expand the business.
- **Gave Maria credibility** with lenders, increasing her chances of securing favorable terms for business loans during the time before the transfer.

Unlike Maria, many business owners mistakenly believe they only need to know the value of their business when they're ready to sell. This is not true. Just as the early estimate helped the Garcias make informed decisions, knowing your business's worth today can provide a benchmark for growth and planning. This "financial roadmap" can help guide you toward your goals and enable you to measure your progress along the way.

The Sweet Success example also highlights how an early estimate can help small and large businesses. Among them:

Strategic planning

Understanding your company's approximate value helps you identify areas ripe for improvement, allocate resources effectively, and set realistic goals for future growth.

Informed decision-making

Are you considering a merger, acquisition, partnership, or exploring financing options? Knowing the range of your business's value empowers you to make confident decisions that align with your long-term objectives, allowing you to assess opportunities and negotiate from a position of strength.

Succession planning

A comprehensive valuation can be the cornerstone of a seamless ownership transition. It ensures a fair distribution of shares among family members or potential buyers, minimizing conflict and ensuring business continuity.

Risk mitigation

Regular valuations highlight potential vulnerabilities in your business operations. By actively identifying these issues, you can take corrective measures before they erode your business's value.

Attracting investors

A well-documented valuation demonstrates transparency, instills confidence, and can significantly improve your chances of attracting investors and securing funding at favorable rates.

Tax implications

Understanding your business's value allows you to consider the tax implications of various transition paths, such as a sale or estate transfer.

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How to approach determining your business's value

A formal business valuation often involves the cost of a comprehensive analysis by a qualified appraiser. That could range from thousands to tens of thousands of dollars, depending on company size. But there are several less expensive methods you can use to obtain an initial estimate:

Financial analysis

Start by scrutinizing key metrics such as revenue, profit margins, cash flow, and debt levels to gain a baseline understanding of your financial performance.

Market comparison

Survey comparable businesses in your industry that have recently sold or are publicly traded. Analyze their valuation multiples, such as price-to-earnings ratio or price-to-sales ratio, and gauge how your business stacks up against its peers.

Asset-based approach

Evaluate the value of your tangible assets, such as property, equipment, and inventory, as well as intangible assets like intellectual property and brand recognition.

Discounted cash flow (DCF)

Project your business's future cash flows and discount them back to their present value. This is a forward-looking approach that considers your business's growth potential.

Example: Finding sweet success with a DCF

A discounted cash flow analysis is commonly used for the type of estimate provided to Maria and Sofia. A DCF analysis can benefit Sweet Success by:

Projecting future cash flows

Factoring in historical financial data, industry trends, and their own business plans can help Maria and Sofia forecast Sweet Success's future cash flows.

Determining the discount rate

The discount rate is known as the weighted average cost of capital (WACC), the determination of which is crucial in a DCF analysis. WACC reflects the risk associated with investing in the business, which is calculated by weighting the cost of equity and the cost of debt. For Sweet Success, other factors might include prevailing interest rates, the company's debt levels, and the overall risk profile of the bakery industry.

Calculating the present value of future cash flows

By discounting the projected future cash flows back to their present value using the WACC, Maria and Sofia can estimate the current worth of those future earnings.

Determining the terminal value

Estimating the terminal value, or the value of the business beyond the projection period, involves factors such as long-term industry growth rates and potential sale values.

Estimating the intrinsic value

The perceived or calculated value of a company — its intrinsic value — can be determined by adding the present value of the projected cash flows to the terminal value. Knowing the company's intrinsic value helps provide a fair basis to transfer ownership to Sofia and can give Maria confidence about her retirement plans.

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Important considerations

While an approximation can often suffice for early planning or internal strategies, a formal valuation is indispensable when selling your business, resolving legal disputes, or seeking significant investor funding. A qualified business appraiser has the expertise and experience to conduct a thorough analysis and provide an unbiased assessment of your business's worth.

Keep in mind the range of your business's value is not static — it fluctuates with market conditions, industry trends, and your company's performance. You should periodically reevaluate your business to stay informed and adapt your strategies accordingly.

Key takeaways

At first, an early valuation appraisal of your business may appear to be an unnecessary expense, but it can be a wise investment. The earlier you understand the range of your business's value and identify potential issues and

opportunities, the more you are empowered to make informed decisions that drive long-term growth, mitigate risks, and maximize your business's value over time.

Failing to obtain an appraisal of your business's approximate value can result in missed opportunities, hasty decisions, and difficult transitions when it's time to move on. An up-to-date understanding of your business's worth is crucial to make informed decisions, build value strategically, and achieve your desired financial outcomes.

So, don't wait until you are ready to sell. Speak with your KeyBank relationship manager to explore whether a formal valuation or another method might be the right approach to understanding your business's worth.

For more information, please call your relationship manager.

The Key Family Wealth BAS team is dedicated to providing guidance and support to privately held business owners like you. Specifically, the BAS team helps owners prepare for an eventual business transition with strategies and advice on how to maximize the after-tax value of a business transition.



Sources:

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