The Siburg Company, LLC
Finance and Operations
Business Development
Mergers and Acquisitions
6347 E. Windstone Trail
Cave Creek, AZ 85331
(480) 502-2800
(480) 502-2804 fax

Reasons for Business Valuations Being Lower

By Daniel R. Siburg, CPA, CVA and Howard W. Fisher

The value of a business is affected by numerous factors such as revenue growth, profitability, and the economic factors affecting the industry in which the company operates. This article will provide an overview of how three business valuation approaches, the Liquidation, Market, and Income approaches have been affected by the downturn in the economy and their resulting lowered business values.

Liquidating for Less

Liquidating a company is the most extreme method of valuing a business, but this method is a practical way of valuing a business, especially during an economic downturn. The basis of a liquidation valuation is to consider that the business is no longer a going concern. To get a true liquidation valuation would require that a business sell all of its assets and use the proceeds from the sale of the assets to pay off all the liabilities of the business and, if any money remains, the owners receive a liquidating dividend. The liquidating dividend is the value of the business.

The slowdown in the economy has forced more businesses to liquidate. During the liquidation process, business owners may discover that the book value of their assets may be overstated as compared to the actual market value. The gap between book value and market value has been further widened by the glut of the same type of assets in the resale marketplace, which has lowered the value of business assets being liquidated.

The resale market for liquidated assets has also been hurt by the lack of available credit for the brokers who buy the assets of businesses that are liquidating. In addition, the retail market value of used equipment is suffering because the buyers of used equipment are also experiencing the inability to obtain credit. This lack of credit for both the broker and the buyer of used equipment is another reason that there is a glut of used equipment in the resale marketplace and the resulting low values for assets sold during liquidation of a business.

The combination of both more business liquidations and the tightened credit market has resulted in the fact that businesses are liquidating for less value.

Market Values are Lower

Market Valuation Approach uses two methods – one that compares the business to public companies in the industry and a second that uses like-kind transactions for companies that have been sold within the same industry. Market valuation methods for determining a business's value are generally easy to understand for both buyers and sellers. It is also easy to understand that when there is an economic downturn that negatively impacts the entire marketplace, business values will be lower too.

Valuation multipliers, such as seven times Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) or one times Revenue are no longer valid multipliers for valuing businesses. These historical valuation multipliers have been adjusted downward to reflect a business's value in today's marketplace. The valuation multipliers of just a few years ago are unlikely to be seen again for many years into the future, and have been adjusted to reflect the higher risk and related lower value being placed on a company.

Databases of business sales that provide information on like-kind transactions of similar companies may have limited recent sales transaction information, as the volume of transactions in the current marketplace has greatly decreased. In addition, the transaction information in these databases will show much lower purchase price values for businesses that have recently sold. The transaction information in the databases from just a few years ago will show companies selling for higher values, but these transactions may be deemed to be irrelevant by buyers when determining the value of a business, as the historical transaction information is lacking the validity and reality of the current marketplace.

Therefore, the market approach methods for valuing business are resulting in business valuations being lower.

Income Approach: These Methods Use Historical Financial Data

The Income Approach is comprised of different methods that, in most cases, use historical financial information to develop trends to project the future performance of a business and its value. Due to the economic downturn during the past couple of years, businesses have had lower revenues and earnings. This recent historical financial information is going to be used to develop the pro forma financial models that help to determine the future performance of the business and its value.

Financial models used for income valuation methods generally use three to five years of historical financial information to forecast the future financial performance of a business for the next five to ten years. If the model uses five years of historical financial information and the most recent three years of financial data reflect lower performance by the business, then the forecasted financial performance should be lower or flat. Simply stated, if three of the five years, or 60%, of the historical financial information

used in a financial model is comprised of lower revenues and earnings, it makes logical sense that the future performance of the business will be less and value of the business will be lower.

Time will Lessen the Impact on Valuation Methods

Over a period of years, the impact of recent lower financial performance can start to work to a business's advantage when determining value. As these lower performance years become the starting points of the historical financial information modeling process, future years will prospectively show positive growth in revenue and earnings. Models that forecast future financial performance will be using the increase as positive trending of future year's revenues and earnings thus resulting in a higher business value.

It could take three to five years for time to lessen the impact of the recent economic downturn on business valuations. This will require that a business returns to a having steady growth in revenues and earnings over a period of years while the three to five years of negative historical performance are being dropped as the basis for projecting the future financial performance. As each year of negative historical information is replaced, the value of the business should gradually increase year over year. The sooner a business is able to show better than expected financial performance, the impact of the negative historical financial information will be reduced, increasing the value of a business faster and providing the seller with higher business value.

Economic Downturns Give Buyers an Advantage in Acquisitions

This article has provided an overview of how economic factors will and do have an effect on the value of a business. Because business valuation approaches and methods use the current and historical financial information to model a business's future financial performance, during an economic downturn, weaker financial performance will result in a lowered business valuations that favor a buyer. Due to the passage of time, a business's lower historical financial performance is diminished from the valuation approaches and methods. The valuation processes will then begin to show an upward trend, which will work in the favor of the seller, resulting in a higher business value.

The Siburg Company, LLC is a boutique consulting firm specializing in the areas of financial and operational consulting, business development, and mergers and acquisitions.

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Daniel R. Siburg, CPA, CVA

Managing Director

Dan is the Managing Director of The Siburg Company, LLC and has experience as both a President and Chief Financial Officer. He has helped companies to improve operational functions and organization to manage costs and increase revenue streams, while implementing strategic policies and procedures that focus companies on profitability.

Howard W. Fisher
Associate

Howard has had success operating four publishing companies. He has founded, built and sold two successful trade book publishing companies, one to a major newspaper chain and one to a major New York publisher. Howard now is a consultant for The Siburg Company, LLC in the areas of business development and mergers and acquisitions.

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www.TheSiburgCompany.com