

Chapter 4: Business Valuation

When valuing the business, the most difficult task is adjusting the income and expense statements as well as the balance sheets of the operation. This section focuses on the adjustments and nuances of making these adjustments, as well as the most typical techniques used to value a business. These techniques have been simplified for the reader.

Adjusted Balance Sheet (Business Valuation)

Overall, this valuation method is used to value a company as a going concern. However, it has a number of shortcomings in that it does not consider intangible assets such as: assembled workforce, trademarks, customer lists, technical know how, etc. Most importantly, if a buyer were to “start the business from scratch,” then this buyer would probably purchase all of the assets at a liquidation value rather than under a value in use definition (see Table 6-2 on page 161). In summary, this valuation methodology is most important to the insurance industry and financial lenders, and it usually represents the floor value of a business.

As an example of an adjusted book methodology, look at Table 4-1 on page 96 and compare the adjusted book values to the values concluded by the market and income approaches (see Table 4-17 on page 114).

With the adjusted balance sheet method, goodwill should also be factored in. Most companies sell for their adjusted book value plus a premium of zero to two times EBITDA. For our subject company, this would result in a premium (goodwill value). The calculation would be an EBITDAR of \$1,024,863 multiplied by 1.5 to equal an additional value of \$1,537,294 of value. Total invested capital would equal \$3,782,421 [$\$2,528,296 + 1,100,260 + 109,244 + 44,621$] and after subtracting out the \$1,254,125 of interest bearing debt, the equity value would be \$2,528,296. If we add the goodwill, then the equity value would be \$4,065,590 ($\$2,528,296$ adjusted equity + $\$1,537,294$ in adjusted goodwill).

Table 4-1: Sample Adjusted Balance Sheet

	Book Value	Adjustments	Market Value
Current Assets			
Cash & Equivalents	\$213,535		\$213,535
Inventory	230,500	(6,600)	223,900
Other Current Asset	53,210	(5,300)	47,910
Total Current Assets	497,245	(11,900)	485,345
Gross Fixed Assets			
Equipment and Machinery	438,200	(438,200)	-
Land, Building & Equipment	1,050,000	(1,050,000)	-
Less: Accumulated Depreciation	(165,230)	165,230	-
Market Value of Real Estate & Equipment		3,270,000	3,270,000
Net Fixed Assets	1,322,970	-	3,270,200
Other Assets	250,000	-	250,000
Total Assets	\$2,070,215	\$1,935,130	\$4,005,345
Liabilities and Equity			
Current Liabilities			
Accounts Payable Trade	225,124	(2,200)	222,924
Current Long Term Debt (Real Estate)	109,244		109,244
Current Long Term Debt (Operations)	44,621		44,621
Total Current Liabilities	378,989	(2,200)	376,789
Long Term Debt			
Long Term Debt (Real Estate & Equipment)	776,289		776,289
Long Term Debt (Operations)	323,971		323,971
Total Long Term Debt	1,100,260		1,100,260
Other Noncurrent Liabilities			
Total Liabilities	1,479,249		1,477,049
Shareholders' Equity	590,966	1,937,330	2,528,296
Total Liabilities and Equity	\$2,070,215	\$1,935,130	\$4,005,345

A summary of these adjustments can be seen in Table 4-2.

Table 4-2: Adjustments to the Balance Sheet

Adjusted Value of Equity (not including goodwill)	\$2,528,296
Plus: Long Term Debt	1,100,260
Plus: Current Portion (Operations)	44,621
Plus: Current Portion (Real Estate)	109,244
Total Invested Capital (not including goodwill)	3,782,421
Plus: Goodwill	1,537,294
Total Invested Capital (including goodwill)	\$5,319,715

Market Approach (Business Valuation)

Before applying the market multiples, we need to adjust the cash flow of the subject gas station, stripping out the value of the real estate so as to provide a leasehold value of the business. This allows us to compare apples with apples when comparing our subject gas station with the other public company gas stations that operate predominately under leases.

A summary of the adjustments needed to be made to the cash flows can be seen in Table 4-3. **Adjustments of Cash Flow**

Table 4-3: Adjustments to the Income Statement for Subject Gas Station

	2013	2012
Income Before Taxes*	\$946,446	\$602,380
Depreciation & Amortization (Equip)	45,250	37,501
Interest Expense (Operations)*	9,766	14,144
Interest Expense (Real Estate)*	23,401	33,002
Unadjusted EBITDAR	1,024,863	687,027
Plus: Discretionary Expenses	26,954	29,157
Less: Fair Market Rent**	(224,825)	(224,825)
Adjusted EBITDA	\$826,992	\$491,359
Unadjusted Cash Flow	\$991,696	\$639,881
Plus: Real Estate Interest Expense*	23,401	33,002
Less: Fair Market Rent**	(224,825)	(224,825)
Adjusted Cash Flow	\$790,272	\$448,058

* Figures are taken from the balance sheet and income statements found in Table 2-5 on page 57 and Table 2-6 on page 58 respectively. $(\$9,766 + \$23,401) = \$33,167$

** Fair Mkt Rent = Table 5-30 on page 154

As can be seen in Table 4-3, we need to adjust the cash flow for the ownership of the real estate. This additional value (real estate) will be added at the end of this section. We used a capitalization rate of 6.5% to calculate market rent of our subject gas station. The rate was taken from comparable capitalization rates listed in Table 5-30 on page 154.

Facilities not on a lease will own the real estate and in many cases, will benefit from ownership through appreciation of real estate value over time. As long as the mortgage rates are favorable and do not put the facility in a position

of possible default, then this situation is ideal for the operator. When the operator chooses to sell the operation, he or she will always know that the amount of money he receives will be buffered by the real estate value less any outstanding debt. In a situation where there is high real estate appreciation, this can greatly increase the value of the operations, as it did with our subject company. Lastly, it must be noted, that as an operator pays off the long term debt due on the real estate, the book value of equity will increase over time – this is under the assumption that most retained earnings would not be left in the company but rather be kept by the owner.

Adjustments of Cash Flow

A summary of the adjustments made to the cash flows can be seen in Table 4-3 on page 97. This cash flow is taken from the balance sheet and financials in Table 2-6 on page 58 of our subject gas station.

Choosing Comparable Companies

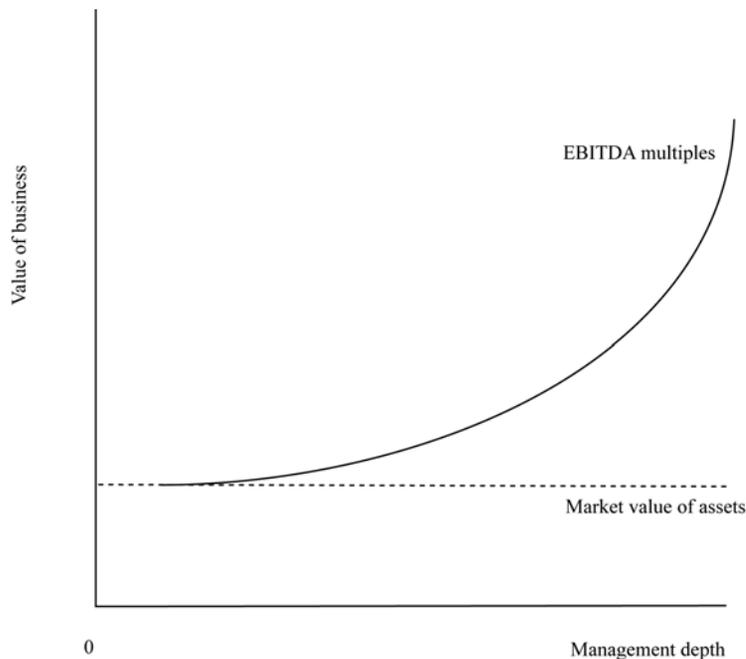
When choosing market multiples, there are many factors you have to look for in terms of comparability. There are generally six steps to using public company information to value a business:

- (1) Review the economy and its relationship to the company
- (2) Review the industry in which the company operates
- (3) Look at the company's financial and competitive position
- (4) Select comparable companies
- (5) Compare the financial information of the subject company to the comparable public companies, and
- (6) Analyze the multiples

Once comparable companies have been found and their financial statements have been studied and adjusted, their stock market's values can be used as a proxy for the company which is being appraised.

Usually a good starting point for finding comparable companies is to find publicly traded companies with the same or similar SIC (Standard Industrial Classification) codes, put out by the U.S. Government. These Standard Industrial Classification books can be found in most libraries or on the internet. Some internet sites where these can be found are at <http://www.osha.gov/oshstats/sic-ser.html> or at <http://www.freedgar.com/Search/BeginSearch.asp>. When reviewing the different classifications, one often finds companies which have different SIC codes, which equates to different lines of business (diverse or integrated), multiple lines of business, a different geographic presence such as an area of the country or domestic and international locations. All of these differences force the valuation expert to make subjective choices when picking comparable companies.

Some of the selected companies that appear to be good comparables at first glance may have to be rejected on a closer look, due to recent acquisitions or divestitures, negative earnings, low number of shares outstanding, recapitalizations, low volume of shares trading (no liquidity), etc. Overall, it is important to state why a comparable company is either accepted or rejected.

Figure 4-1: Relationship Between Management and Company Value

As a last effort, it may be important to use secondary SIC codes for related businesses or industries which have related problems or competitive issues but similar margins. Sometimes companies may have similar manufacturing processes, customers, or distribution channels, among other things.

Finally, when analyzing comparable companies which are publicly traded it is important to know the liquidity of the stock. Look at the bid-ask spread (difference between the purchase price and selling price) and see what this is and when the last trade was, as well as whether these are arms length trades. If the stock does not have a good volume for trading and/or it has a small number of shareholders, then it may not be a good representative company to use as a comparison.

A firm's operating strategy is one of the most important areas to look for when finding a comparable company. Having a similar operating strategy ensures that the comparable companies are subject to the same risk and exposure as well as business cycle. Below is a quick summary of our industry comparables and their operations.

Operating Strategy and Comparable Companies

Autobacs Seven Co, Ltd. (TSE:9832)

Autobacs Seven Co, Ltd operates a chain of franchises that consists of 538 retail stores, which sell automotive related goods and offers services throughout their service bays. The group generates revenue through wholesale operations and retail operations.