

## **WHAT'S IT WORTH – VALUING THE FAMILY BUSINESS**

The assignment to value a family business may be as simple as valuing the corner store or a small franchise operation or as complex as valuing a multi-national conglomerate. A family business is typically successful, large, operates in any business sector, has sophisticated management (with a degree of nepotism) and, incidentally, is owned by a family. Family ownership invariably triggers the need for a valuation and, often, periodic valuations. Reasons for a valuation are not any different than the reasons for valuing any private company.

Matters may include succession, reallocating ownership interests, performance incentives, participation in growth and dividing assets. They all lead to the question, “How much is it worth?” This is a paper about business valuations, what they are (and aren't) and how they fit into family business succession.

Posing the question, “What is the family business worth?” will trigger a number of related questions.

1. What is a valuation?
2. Are there different types and which do we need?
3. When do we need it?
4. Who should do it?
5. What should they value?

These are all valid questions that need answers.

### **WHAT IS A VALUATION?**

A business valuation is an independent assessment of the value of your business. This detailed analysis of your company and the market sector provides an indication of future potential. It is an essential management tool for many planning strategies. A business valuation applies a rigorous set

of standards to determine value; Canadian standards are set by the Canadian Institute of Chartered Business Valuators (CICBV). Canadian Business Valuators (CBV) are different from Chartered Accountants (CA) who work with the past to make their financial statements,

“CBVs look to the future to determine what is most likely to happen and place a value on that...The Canadian Institute of Chartered Accountants (CICA) recognizes CBVs as the exclusive experts in the field of business valuation in Canada,”<sup>1</sup>

CBVs are accepted by CAs, applying the designation CA•CBV to CAs who work in a business valuation specialty. The CA•CBV is one of six specialist designations recognized by the CICA and the only designation for business valuations.<sup>2</sup>

A valuation report prepared by a Chartered Business Valuator must provide one of three levels of service as outlined in **Standard #110** of the CICBV Handbook.<sup>3</sup>

**Comprehensive Valuation Report** – a conclusion as to the value of shares, assets or an interest in a business that is based on a comprehensive review and analysis of that business, its industry and all other relevant factors, adequately corroborated and generally set out in a detailed Valuation Report.

**Estimate Valuation Report** – a conclusion as to the value of shares, assets or an interest in a business that is based on a limited review, analysis and corroboration of relevant information, and generally set out in a less detailed Valuation Report.

**Calculation Valuation Report** – a conclusion as to the value of shares, assets or an interest in a business that is based on minimal review and analysis and little or no corroboration of relevant information, and generally set out in a brief Valuation Report.

The determination of the appropriate level of service depends on the purpose of the value indication and the intended user(s). A Comprehensive Report carries the highest cost with a substantially greater independent analysis of the business, industry and relevant economic conditions and detailed reporting. This level of service is most appropriate for court hearings or public reporting,

“The opinions of CBVs are respected and recognized by the courts in shareholder, partnership, securities, intellectual property and marital disputes, damage quantification, insurance losses, personal injury claims, patent infringement and breach of contract cases.”<sup>4</sup>

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<sup>1</sup> [www.cicbv.ca/profileofaCBV](http://www.cicbv.ca/profileofaCBV)

<sup>2</sup> [www.icaa.ab.ca/beyond/designations.shtml](http://www.icaa.ab.ca/beyond/designations.shtml)

<sup>3</sup> Handbook Standard #110 Valuation Reports, Copyright 2007, CICBV

<sup>4</sup> [www.cicbv.ca](http://www.cicbv.ca)

An Estimate Report is the most commonly provided level of service and is appropriate for most users. The valuator conducts a significant amount of external research and analysis, balanced with management information. The report outlines the major considerations allowing the reader's understanding without in-depth detail. An estimate or a comprehensive report is generally used for annual updates required when there are shareholder employees and an annual price is set for changes in shareholdings.

A Calculation Report carries the lowest cost but has a lower level of assurance. The valuator relies more on management's information as opposed to independent research and analysis. This level of service is more appropriate for internal management decisions requiring broad range valuation advice. Management may use a calculation prepared annually as a benchmark for performance.

**Standard #110** and related information is the basis for deciding on the appropriate valuation report for the client. The client and the valuator need to come to an understanding that addresses the needs of the client. This understanding should be captured in an Engagement Letter that is prepared by the CBV and agreed to by the client. The CBV has flexibility as to the style and content of the report as long as it contains the requirements outlined in **Standard #110** and appendices. The common-sense guideline is:

“Disclosure should be sufficient to allow a shareholder to understand the basis of the valuation or fairness opinion and to form a reasoned view on the opinion conclusion.”<sup>5</sup>

When the business owner wants to answer the question, “What is my business worth”, the CBV helps him decide what needs to be valued. The definition of a valuation report prepared by a CBV states that it could include, “a conclusion as to the value of shares, assets or an interest in a business.”

What is unstated is that the CBV may turn to other appraisers and valuers to help him properly value the shares, assets or interest in a business. A CBV is fully capable of valuing monetary and intangible assets. He is familiar with the techniques for valuing real property and equipment but real estate should be valued by a member of the Appraisal Institute of Canada (AIC)<sup>6</sup> and equipment

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<sup>5</sup> [Handbook](#) Appendix A to Standard #110 Valuation Reports, Copyright 2007, CICBV

<sup>6</sup> [www.aicanada.ca](http://www.aicanada.ca)

should be appraised by someone with equipment certification provided by the American Society of Appraisers (ASA)<sup>7</sup>. The CBV is typically the first point of contact in a valuation and he will identify for the client the need for other valuation experts.

A valuation, in its most basic form, is a value or a range of values that represents the valuator's conclusion of what he expects the business will earn in the future, adjusted to today's value. In other words, we are converting future expectations to a value today. Because a crystal ball is not in a valuator's tool kit, other techniques that focus on valuing future expectations are utilized.

The starting point in a valuation is the definition of fair-market value. This and all other valuation terms have been agreed to by a number of internationally recognized societies and organizations including: American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts and The Institute of Business Appraisers.

Fair-market value is defined as:

“the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. [NOTE: In Canada, the term "price" should be replaced with the term "highest price"]”<sup>8</sup>.

The fair-market value definition contains many assumptions, which should make clear that selling price and fair-market value are not interchangeable. Selling price can be influenced by a number of the factors that are addressed (assumed away) in the fair-market value definition. For example, a motivated buyer (a purchaser of a sports franchise) may pay more than fair-market value. Very rarely does a sale contain all of the attributes of the fair-market value definition.

Other factors that are not part of the value definition also need to be addressed; it is important to do this as part of setting the terms of engagement and again in the valuation report. Each of the following considerations can either be addressed as a negative (as illustrated) or as positive.

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<sup>7</sup> [www.appraisers.org](http://www.appraisers.org)

<sup>8</sup> [International Glossary of Business Valuation Terms, bvappraisers.org/glossary/glossary.pdf](http://InternationalGlossaryofBusinessValuationTerms.bvappraisers.org/glossary/glossary.pdf)

## **SPECIAL PURCHASERS**

The notional value does not consider possible synergistic benefits or economies of scale that might accrue to a special purchaser. We have not identified any special purchasers, and in order to calculate the benefits that may accrue to special purchasers, the specific synergies realized by each special purchaser must be assessed.

## **VALUATION DISCOUNTS**

A Lack of Marketability discount reflects the illiquidity of an interest in a closely held corporation. The business is not readily marketable because of the absence of a ready market where it can be sold. We will not apply this discount if the intended use does not include an immediate sale and if sufficient income can be earned from the operation (compensation) during the time that the operation is exposed to the market to offset any loss that would arise because of a delayed sale. The value of a business with a key patent that has a limited life could decline; any delay reduces the value of the income stream from the patent.

A Minority Discount is applied when a minority shareholder is not able to influence company strategy, operations, or the amount and timing of the return on the investment in the company. When these criteria are present and unaccounted for in a Shareholder agreement, this discount may be considered. A Minority Discount often is not considered because the engagement is to value 100% of the operating entity. When a Minority Discount is applied the report generally starts with the “en bloc” value and then provides a range of discounts that should be considered, taking into account the rights of the minority shareholder and trends in settlements and legal actions.

The most important part of a business valuation is to understand the business. This arises, in part, from a review of financial information. Just as important, owners active in the business and senior management should be interviewed early in the valuation. It is imperative that the valuator visit the operation and understand the nature of the service or product being sold. As the process is repeated with each valuation, it quickly becomes apparent that every business has unique attributes that will impact the valuation conclusion.

An asset in identifying unique aspects of each business is to complete a Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis. The focus will be on management, employees, markets, competition, suppliers and the product or service being offered. The key to every valuation is to keep an open and inquiring mind and listen to the story!

The importance of this aspect of a valuation is reinforced when valuations are completed on a number of companies in the same industry. The valuator must not conclude that each company is cut from the same piece of cloth. Statistical information is provided on financial ratios and sales transactions for companies in different industry groups.<sup>9</sup> Transactions are sorted by industry Standard Industrial Classification (SIC) code. The information will provide a range, the median and the average; this is just the starting point for using the information. The specifics of the business being valued must be understood. For example, two metal fabricators may be located in the same industrial park in south Edmonton. Their value could differ dramatically if one is serving traditional oil and gas exploration customers and the second has developed a market in the oil sands. The overriding caution is that in each industry, be it a metal fabricator, hard goods wholesaler or professional services firm, the business being valued will offer sufficient unique attributes that drawing a value conclusion is impossible without first adjusting for the unique attributes of the business being valued.

Industry experience is important. A valuator familiar with a particular industry will be better equipped to complete a SWOT analysis. Key financial ratios that indicate financial strength are often unique to each industry. For example, a professional services firm should manage occupancy costs so that they do not exceed more than 10% of revenues. Acceptable revenues per employee for an engineering firm are in the range of \$120,000 to \$150,000 per employee.

Typical working capital requirements are 15% to 20%. Working capital is a liquidity ratio (current assets minus current liabilities) addresses the question, "Does the business have sufficient assets to pay its current liabilities?" Variances, depending on the direction, may indicate a problem or exceptional management.

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<sup>9</sup> Examples include: Pratt's Stats Private Transaction Database, [www.bvmarketdata.com](http://www.bvmarketdata.com); RMA Annual Statement Studies 2006 – 2007, The Risk Management Association (RMA) [www.statementstudies.org](http://www.statementstudies.org); and, 5-Year Industry Report, Integra Information, A Division of MicroBilt Corporation [www.integrainformation.com](http://www.integrainformation.com).

A rule-of-thumb can be developed for any industry. A rule-of-thumb is simply an average; if 100,000 chiropractic firms are sold and the selling price is equivalent, on average, to 65% of one year's revenues, then that becomes the rule-of-thumb. There are a number of problems with rules-of-thumb. Because they are an average, they do not recognize the unique attributes of each business. The average can encompass a large range; for chiropractors, this can range anywhere from 15% to 125% of revenues.

A transaction set by a rule-of-thumb will frequently leave dollars on the table. What makes a rule-of-thumb even more damaging is it is often misquoted and does not transfer between industries. For example, a financial advisor of a chiropractic firm had advised his client that 100% of one year's revenues was the industry standard. This process started with the client having unrealistic expectations of the value of his business.

These expectations may or may not be warranted depending on the quality of the chiropractor's client base, his reputation, support services, location and other factors. An obvious weakness of a revenue-based rule-of-thumb is that it ignores the cost structure of the particular business being valued.

## **VALUATION APPROACHES**

A valuation utilizes one of two basic approaches, either the liquidation approach or the going-concern approach.

### **1. LIQUIDATION APPROACH**

The liquidation approach is used when the expected proceeds from the disposal of the business assets will have a greater value than the present value of future cash flows discounted for risk. The point of a liquidation analysis is to determine the net cash that will be available to the business owner when the balance sheet is converted to cash. Each asset and liability is reviewed to determine its impact on cash, including assets and liabilities not identified on the balance sheet. Any goodwill is written off.

Intangible assets such as leasehold interests, client lists, procedures manuals, trade name, supplier contracts, technical documentation and literary copyrights should be identified and assigned a value. Identifiable intangible assets are most often valued using an income approach because their value is best represented by what they will generate in terms of cash flow, net of contributory expenses. Liabilities are identified and deducted, applying a liquidation approach. Liabilities will include disposition costs and taxes.

## **2. GOING-CONCERN APPROACH**

A going-concern approach assumes a continuing business enterprise with the potential for economic future earnings. Where a business has commercial value as a going concern, one or more of three valuation methods are applied; the adjusted-net-asset approach, the income/cash-flow approach and the market approach.

## **3. THE ADJUSTED-NET-ASSET APPROACH**

The objective of the business valuator using this approach is to restate the historical cost balance sheet to fair market value. This discloses the true economic value of all assets and liabilities of the target company. The business valuator starts with the balance sheet of the entity and adjusts all assets and liabilities to their fair-market value.

Some fine-tuning of the fair-market value definition is required in this process. Certain assets may have a higher fair-market value if they are valued absent any consideration that they are utilized as part of the business. For example, a parking lot adjacent to the business may be appraised at a higher value if it were sold and developed. Notwithstanding that opportunity, it is needed as a parking lot for the business being valued and the valuator and client will likely conclude that fair-market value (value-in-use) is the appropriate value term for individual assets being valued.

The adjusted-net-asset approach is generally used as a secondary approach because goodwill, which can be a significant part of a business's fair market value, is not included. The adjusted-net-asset approach will, therefore, not render a true fair-market value conclusion. The approach is, however, useful as a risk-measurement indication; tangible assets and identifiable intangible assets

generally have a lower risk and return when compared to goodwill and intangible assets not separately valued. In other words, the adjusted-net-asset approach provides a floor for fair-market value otherwise determined.

A secondary benefit of this approach is that it helps with identifying redundant assets. Redundant assets (possibly better described as non-operating assets) are those assets that are owned by the business but not required in its day-to-day operations. These assets are, therefore, separated from the business and added to the value otherwise determined because they can be disposed of without adversely affecting the on-going operations of a company.

This process is critical to the valuation as the value of these assets is not reflected in cash flow and, therefore, would not be captured by the income approach value estimate. Redundant assets could include certain discretionary assets such as an art collection or excess real estate.

#### **4. THE INCOME/CASH FLOW APPROACH**

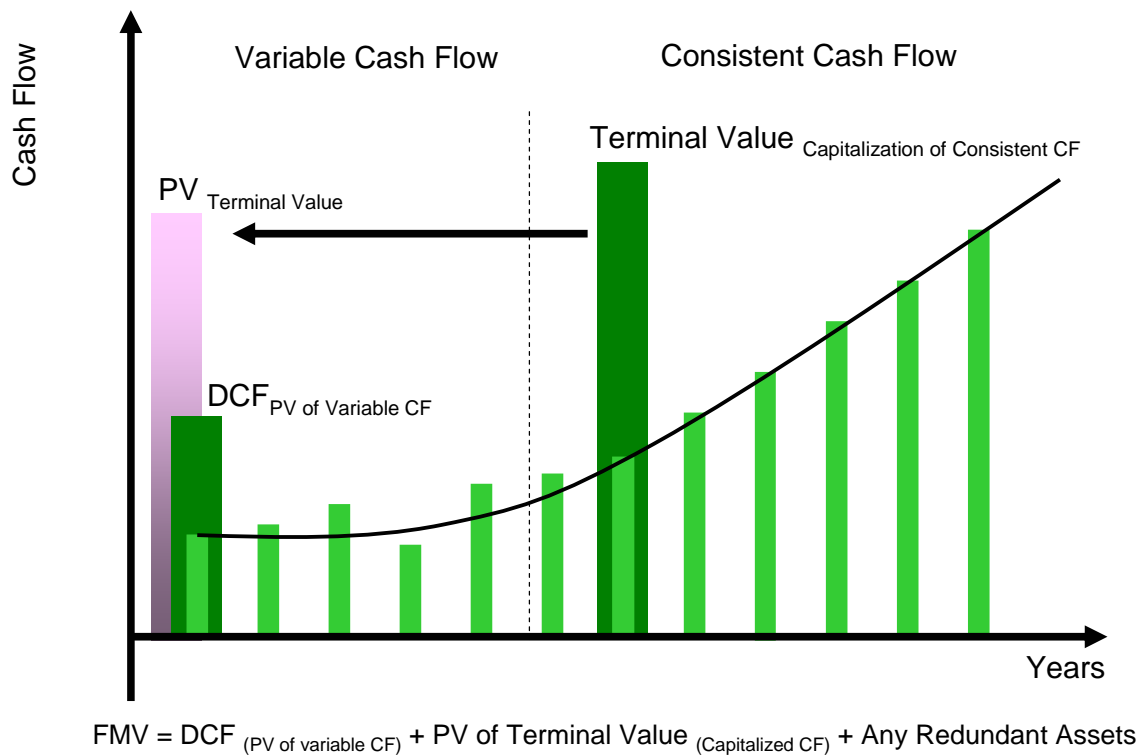
Using this approach, the business valuator quantifies the present value of future benefits associated with ownership. The estimated future benefits that accrue to an owner are discounted or capitalized at a rate appropriate for the risks associated with those benefits. Common methods within this approach include the discounted-cash-flow approach and the capitalized-cash-flow or capitalized-earnings approach.

These approaches have two basic components: future cash flow and a capitalization or discount rate. The capitalized-cash-flow/earnings approach is used when future cash flows are predictable. The valuator estimates a level of maintainable cash flows from current business operations. Adjustments are made for non-recurring and discretionary expenses and to take into account future trends. Rent and income taxes are two obvious examples of historic expenses that should be adjusted when concluding the company's maintainable cash flow.

A capitalization or discount rate is applied to maintainable cash flow to convert it to value. The difference between a discount and capitalization rate is that the capitalization rate incorporates expected growth, the discount rate does not.

To illustrate, if maintainable-cash-flow is \$1,500,000 and no cash flow growth is expected over time, the capitalization rate is 16% and value is \$9,375,000. The capitalization rate used for maintainable cash flow accounts for expected growth of that cash flow. For example, if operating cash flow is expected to grow on average 3% per year net of inflation over the long term, the capitalization rate will be adjusted by reducing 16% by the growth rate of 3%. The lower capitalization rate, now 13%, translates to a higher value of \$11,538,000.

The discounted-cash-flow (DCF) approach is applied when future cash flow is expected to grow or contract at varying rates over time. As a result, a DCF approach is more often used in a start-up industry. The cash flow forecast will be projected far enough into the future to capture the initial growth spurt or volatility that may be expected. When cash flow becomes predictable, value is capped by calculating a terminal value. The terminal-value calculation (TMV) is identical to the capitalized cash flow/earnings approach except that it is assumed to take place of the future value is added to value otherwise determined by the discounted cash flow approach. A graphic example will help to illustrate this approach:



Discount rates capture the risk of a project. They do this by taking into account a long-term risk-free rate, equity-risk premium, industry-risk premium, small-company-risk premium and specific-company-risk premium. The specific-company-risk premium takes into account qualitative factors.

## **5. THE MARKET APPROACH**

Using this approach, the business valuator determines the fair market value of a business by reviewing actual transactions of companies in the subject company's industry or similar industries. This approach measures value based on prices set by market participants and their prospective expectations of future benefits associated with ownership.

The accompanying worksheet arrives at a value solution for Big Trucker. It illustrates that both public and private company market data can be used to illustrate market value. Public company data is based on the market price of publicly-traded stock. Private company data is based on the selling price of companies, either assets or shares.

The amount of data available for analysis needs to be edited to a few key indicators of value. In this instance, we determined, after reviewing the data and the industry, that both a revenue multiplier and an EBITDA multiplier were appropriate value indicators. The valuator, in this instance, determined that a revenue multiplier of .50 to .75 and an EBITDA multiplier of 6.5 to 7.5 is appropriate after a review of the market.

Neither multiplier conclusion is a mathematical determination, i.e. it is not the median or the average of the surveyed companies. The circumstances of each company are taken into account plus the timing of each transaction, the comparability of the company, nature of the consideration, reasons for sale and other factors.

The market approach has some inherent weaknesses though it gives insight into investor actions in the marketplace. Reliance on market transaction data has some limitations, primarily due to lack of access to sufficient financial information and knowledge of adjustments required for historic cash flow and earnings to prospective cash flows. Information is limited on the structure of the transaction, specifically non-cash consideration, no-compete arrangements, management contracts, earn-outs and other arrangements that could have a significant impact on price. The particular circumstances surrounding each market transaction are also unknown, for example, the motives for the sale, the

comparable negotiating strengths of the vendor and purchaser, alternatives to the transaction consummated, etc. These considerations potentially create a significant impact on the final price. As a result, the market approach is often used as a reasonable cross-check to the value conclusion from the income/cash flow approach.

The family will, at some point, ask the question, "What is my business worth?" This question may be triggered by something as simple as the desire to benchmark the family's success and the response will become part of a process, be it a succession plan, a decision to sell the company to outsiders, a decision to invite non-family management to participate or a decision to divide assets between family members. The answer: have the business valued by a valuation expert.

## MARKET TRANSACTION SUMMARY

## Comparable Companies

Private Company Transaction Company Name	Recent Year Sales	Selling Price (MVIC)	EBIT	EBIT Margin	EBITDA	EBITDA Margin	Revenue Multiplier	MVIC / EBIT	MVIC / EBITDA
Company A	\$96,872,343	\$80,793,000	\$6,779,211	7.00%	\$12,396,061	13.00%	0.83	11.92	6.52
Company C	\$69,256,000	\$34,999,000	\$2,462,000	3.55%	\$6,962,000	10.00%	0.51	14.22	5.03
Company F	\$40,106,155	\$37,250,000	\$3,936,878	9.82%	\$5,299,907	13.00%	0.93	9.46	7.03
Company L	\$70,015,000	\$36,068,000	\$3,510,000	5.01%	\$5,189,000	7.41%	0.52	10.28	6.95
Company S	\$65,251,150	\$53,000,000	\$4,087,123	6.26%	\$12,730,456	19.51%	0.81	12.97	4.16
<b>Average</b>	<b>\$68,300,130</b>	<b>\$48,422,000</b>	<b>\$4,155,042</b>	<b>6.33%</b>	<b>\$8,515,485</b>	<b>12.58%</b>	<b>0.72</b>	<b>11.77</b>	<b>5.94</b>
<b>Median</b>	<b>\$69,256,000</b>	<b>\$37,250,000</b>	<b>\$3,936,878</b>	<b>6.26%</b>	<b>\$6,962,000</b>	<b>13.00%</b>	<b>0.81</b>	<b>11.92</b>	<b>6.52</b>

Public Company Company Name	Recent Year Sales	Selling Price (MVIC)	EBIT	EBIT Margin	EBITDA	EBITDA Margin	Revenue Multiple	MVIC / EBIT	MVIC / EBITDA
TransForce Income Fund	\$1,928,828,000	#####	\$141,364,000	7.33%	\$248,456,000	12.88%	0.79	10.74	6.11
Vitran Corporation Inc.	\$661,609,333	\$376,151,806	\$26,998,667	4.08%	\$47,498,667	7.18%	0.57	13.93	7.92
Mullen Group Income Fund	\$1,169,110,000	#####	\$207,494,000	17.75%	\$280,476,000	23.99%	1.65	9.28	6.87
Contrans Income Fund	\$490,506,000	\$385,730,030	\$38,758,000	7.90%	\$56,008,000	11.42%	0.79	9.95	6.89
Clarke Inc.	\$208,181,000	\$453,999,980	\$31,559,000	15.16%	\$34,954,000	16.79%	2.18	14.39	12.99
<b>Average</b>	<b>\$891,646,867</b>	<b>\$932,220,317</b>	<b>\$89,234,733</b>	<b>10.44%</b>	<b>\$133,478,533</b>	<b>14.45%</b>	<b>1.19</b>	<b>11.66</b>	<b>8.16</b>
<b>Median</b>	<b>\$661,609,333</b>	<b>\$453,999,980</b>	<b>\$38,758,000</b>	<b>7.90%</b>	<b>\$56,008,000</b>	<b>12.88%</b>	<b>0.79</b>	<b>10.74</b>	<b>6.89</b>

<b>BIG TRUCKER</b>	<b>\$200,000,000</b>		<b>\$7,000,000</b>	<b>3.50%</b>	<b>\$9,000,000</b>	<b>4.50%</b>			
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Revenue Multiplier	<b>Revenue</b>	\$ 200,000,000	0.50	0.75
	Market Value of Invested Capital		\$100,000,000	\$150,000,000
	Less: Interest Bearing Debt		(\$15,000,000)	(\$15,000,000)
	Plus: Redundant Assets		-	-
	<b>Value of Equity</b>		<b>\$85,000,000</b>	<b>\$135,000,000</b>
	Rounded		<b>\$85,000,000</b>	<b>\$135,000,000</b>
EBITDA Multiplier	<b>Earnings before Interest, Taxes and Depreciation</b>	\$ 9,000,000	6.50	7.50
	Market Value of Invested Capital		\$58,500,000	\$67,500,000
	Less: Interest Bearing Debt		(\$15,000,000)	(\$15,000,000)
	Plus: Redundant Assets		-	-
	<b>Value of Equity</b>		<b>\$43,500,000</b>	<b>\$52,500,000</b>
	Rounded		<b>\$43,500,000</b>	<b>\$52,500,000</b>

## Rules of Thumb

## Trucking Companies

5 times Earnings before Interest and Taxes

<b>Earnings before Interest and Taxes</b>	\$ 7,000,000	5.00	
Market Value of Invested Capital		\$35,000,000	
Less: Interest Bearing Debt		(\$15,000,000)	
Plus: Redundant Assets		-	
<b>Value of Equity</b>		<b>\$20,000,000</b>	
Rounded		<b>\$20,000,000</b>	

2-3 times Earnings before Interest, Taxes and Depreciation

<b>Earnings before Interest, Taxes and Depreciation</b>	\$ 9,000,000	2.00	3.00
Market Value of Invested Capital		\$18,000,000	\$27,000,000
Less: Interest Bearing Debt		(\$15,000,000)	(\$15,000,000)
Plus: Redundant Assets		-	-
<b>Value of Equity</b>		<b>\$3,000,000</b>	<b>\$12,000,000</b>
Rounded		<b>\$3,000,000</b>	<b>\$12,000,000</b>

## Notes:

EBIT - Earnings before Interest and Taxes

EBITDA - Earnings before Interest Taxes and Depreciation

MVIC - Market Value of Invested Capital, equity and debt assumed in the purchase

WACC - Weight Average Cost of Capital - includes return to both debt and equity holders