

What Is Your Business Worth? *Contracting Business – October 2004*



What is the value of your HVAC business? I'd bet more than one reader is thinking that the value of his business is whatever someone is willing to pay for it. This common notion is both right and wrong. In reality, the value of your business is a calculation based on several different characteristics and factors that together make up your business. Furthermore, your business may have more than one value, depending on what the valuation is to be used for.

One type of value is a "Fair Market Value". For estate planning purposes, the IRS generally accepts a Fair Market Value. As defined by the IRS, the Fair Market Value of any business is:

"the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties have reasonable knowledge of relevant facts"

What about a valuation for a business transaction – you are in the process of selling your business and you want to know what a buyer might pay? For the sale of your business, a Fair Market Value is an excellent benchmark. Understanding the Fair Market Value of your business will help you successfully negotiate the price, terms and structure of the sale of your business.

Does this mean that someone may offer more or less than the Fair Market Value? Absolutely, buyers acting with a compulsion pay more everyday. A compulsion might be the buyer's need to capture a specific group of customers serviced by your business. Under this scenario, the value of your business is what that buyer is willing to pay.

What is being valued?

Business owners often confuse the difference between a valuation and an appraisal. A business valuation is not an appraisal. An appraisal is used to determine the value of the tangible assets owned by a business and does not take into consideration intangible assets or earnings potential. Certain assets, such as real estate, may be appraised as part of an overall business valuation. Tangible and intangible assets are divided up as follows:

Tangible – vehicles, tools, sheet metal brakes, office furniture, computers, gauges, tools and forklifts

Intangible – telephone numbers, customer list, operating history, company name, files, records, computer files, computer data bases, customer names, customer lists and company records

As you can see, tangible assets are those assets that can be touched or felt whereas intangible assets typically are non-physical. A business valuation is designed to determine the value of both tangible and intangible assets.

Steps in valuation:

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Steps required to value an HVAC business are as follows:

1. Determine the purpose of the valuation
2. Gather historical financial data
3. Adjust historical financial data
4. Determine which valuation approach works best for the situation
5. Calculate the Enterprise Value
6. Understand the balance sheet and how it effects the final valuation

What is the purpose?

There are several reasons why a business valuation may be required and they are typically separated into two groups; tax valuations and non-tax valuations:

	Tax Valuations	Non-Tax Valuations	
It is important that a tax purposes involved, stricter and can be more costly than a non-tax valuation. For this article, I will assume that the intended purpose of the valuation is to determine a benchmark for the sale of an HVAC business – a non-tax valuation.	Estate tax Gift Tax ESOPS Charitable Contributions	Sale Merger Buy/Sell Agreements Litigation Support (divorce, etc.)	to understand valuation for can be more must follow guidelines

Where are my numbers?

Any business valuation is going to key on the historical earnings of the business. Why? Because a buyer will be interested in a future returns (profits) of the to be purchased business and the single most reliable method of predicting future returns is by analyzing past performance.

What about potential? When I was purchasing HVAC, plumbing and electrical businesses for a publicly traded contractor from 1996 through 2002, so many owners wanted to a value based on their business’s potential - “if only I had more techs”. Here are the facts, every contracting business has greater potential and the buyer knows that. Furthermore, the buyer intends to put forth an effort to achieve that potential. Ask yourself, who should be rewarded for capturing that potential, you or the buyer?

Gather your financial statements from at least three years prior. If you have five years of operating history, better yet. A current value will consider historical data, but will place a greater emphasis on the most recent information. Beyond five years, the data becomes irrelevant to the current valuation.

What are the real numbers?

Having valued approximately 2,000 businesses, only one comes to mind that required no adjustments to determine a true picture of profitability. This indicates that there is a good chance your financial statements will require adjustments before the true financial picture of the business can be understood. Another common term for these adjustments is “add backs”. Common addbacks include, but are not limited to:

- Excessive rent paid on real estate owned by the owner

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- Excessive officer compensation
- Non-reoccurring expenditures
- Expenditures deemed to be “non-business” in nature
- Capital assets purchased and expensed

Shrewd buyers skeptically scrutinize all add backs suggested by sellers. Add backs can be an area of abuse when the seller, trying to report higher profitability to the buyer, adds back actual operating costs as non business expenditures. Nevertheless, add backs are a crucial step in determining the true profitability of any privately held business.

Is there a method to the madness?

There are three generally accepted valuation methods used to value a business and specific situations where one method may be better than the others. The methods are:

1. Market Approach
2. Asset Approach
3. Earnings Approach

Market Approach:

If five HVAC shops in your town, each performing \$1 million a year in residential service sold this year for \$500,000, one could draw the conclusion that the sixth \$1 million a year residential service business would have a value of \$500,000. Simple right? The problem lies in gathering enough data to draw a sound conclusion. During the Consolidation Period (1996-1999), the Market Approach could have been applied as a significant amount of data existed in regards to privately held businesses that sold to public companies. However, applying the Market Approach today is not as easy.

Asset Approach:

The big dollars of any business valuation is not in the tangible assets. Don't get me wrong, your fleet of Fords and Chevrolets costs real dollars and has value to a buyer, but in regards to the overall value, these assets are only a few pieces of the puzzle! The other pieces are the intangible assets. If your adjusted historical financial statements indicate that the business is not capable of producing profits, or worse yet, its survivability is questionable, then the intangible assets have little or no value. In this case, the Asset Approach is used. Valuing an unprofitable business based upon the tangible assets involves determining the market value of all of the assets that are owned by the business.

Earnings Approach:

Where the Asset Approach is used to value an unprofitable/failing business, the Earnings Approach is used to value a business that has demonstrated the ability to return profits and therefore has intangible assets with value.

There are several different methods used to apply the Earnings Approach, all have the same premise – the value of a business is based on a factor applied to an earnings indicator of the business. The most common factor is known as the “multiplier”. A multiplier is applied to an earnings indicator such as adjusted EBITDA, pre-tax net income or after tax net income.

I did not know my company had any EBITDA?

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EBITDA or “earnings before interest, tax, depreciation and amortization” represents the cash flows generated from your business. EBITDA is used as an earnings indicator because buyers are typically concerned about generating enough cash flow to pay for the purchased business. When EBITDA is applied to a multiple, the result is the Enterprise Value.

What is included in the Enterprise Value?

The Enterprise Value includes the following:

- Tangible assets used in the business
- Intangible assets of the business

Not included in the Enterprise Value are:

- Cash
- Accounts receivable
- Accounts payable
- Debt

The earnings multiple:

Whereas the earnings indicator is obtained from the adjusted historical financial statements, the earnings multiple is more subjective. Don’t be fooled, there are sound theories that go into formulating earnings multiples. A multiple represents an expected rate of return for an investment. The higher the risk associated with the investment, the higher should be the expected return. A simplistic way to compare the multiple to an expected rate of return is to divide the multiple by one as demonstrated in the table below:

Multiple	1.0	2.0	3.0	4.0	5.0	10.0
Return	100.0%	50.0%	33%	25%	20%	10%

Based on the above table, would anyone ever use a multiple of 10.0 to purchase an HVAC business? Probably not, considering there are several safer alternative investments (stocks and bonds) that offer a 10.0% return with less risk.. Expecting a 20.0% return, based on the risks of investing in any small business, is probably as low of an expected return as one would accept. That is why multiples used to value contracting businesses exceeding five times EBITDA are uncommon - even back during the Consolidation Period when seemingly unrealistic values were placed on HVAC businesses.

Multiple ranges vary and should be taken into serious consideration when used to value a business. A slight increase or decrease in a multiple can significantly affect the overall value of a business. Assuming that a business reports a historical EBITDA of \$100,000, the Enterprise Value would be as follows utilizing a range of different multiples.

EBITDA	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000
Multiple	<u>2.0</u>	<u>2.5</u>	<u>3.0</u>	<u>3.5</u>	<u>4.0</u>
Enterprise Value	\$200,000	\$250,000	\$300,000	\$350,000	\$400,000

For every ½ point added to the multiple the Enterprise Value of the business increases by \$50,000! Determining the right earnings multiple to be used is subjective and involved. In order to make sure you are not under or overvaluing your business, consider seeking the advice of someone who not only has professional business valuation experience, but has industry specific knowledge.

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Putting it all together:

As an example, assuming your business has an EBITDA of \$200,000 and the correct earnings multiple is said to be 3.5. Also, the business maintains \$20,000 in accounts receivable, \$30,000 in accounts payable and \$150,000 of vehicle debt, the actual Fair Market Value would be as follows:

EBITDA	\$200,000
Earnings Multiple	<u>3.5</u>
Enterprise Value	\$700,000
Plus:	
Accounts Receivable	\$20,000
Less:	
Accounts Payable	(\$30,000)
Vehicle Debt	<u>(\$150,000)</u>
Fair Market Value	<u><u>\$540,000</u></u>

Conclusion:

A common reason for a business owner to need to know the value of his business is in preparation of a sale. Entering into the sale with an understanding of the value of your business will enable you to better negotiate the sales price, terms and structure with a buyer. Because a business valuation is not something a business owner calculates everyday, the steps outlined in this article should be carefully followed in order to ensure that the calculated value is accurate and reliable.

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