

## The 7 Benefits of Annual Valuations

Most owners of privately-held businesses believe that they know what their company is worth. As they have worked to build the business, often from the ground up, they feel that their intuitive value conclusions accurately reflect the fair market value of the firm. In many cases, these business owners are biased in their views towards the firm, and therefore, have an inflated sense of value associated with the business. Though a business owner has their own opinion as to what the business is worth, their value may differ substantially from the value that could be realized in an arms length transaction between a willing buyer and a willing seller. Without a formal valuation of the company, the business owner often has nothing other than a gut feeling to support the value that they attach to the business.

Many business owners are reluctant to hire an independent valuation professional to conduct an initial valuation of the company (let alone an annual valuation) if they do not perceive the need for one. In many cases, there is little perceived need for the owner of a very small business to have a valuation performed, unless of course the owner plans to leave the business to children, needs a loan from a bank when the company's assets alone cannot support the loan, or seeks to sell all or part of the business. These business owners often are individuals who have started or acquired a "lifestyle" business—a business that provides the owner with a job and enables the owner to maintain their desired lifestyle. The lifestyle business could be thought of as a hobby for the business owner—a hobby that earns the owner money.

As compared to a lifestyle firm, some entrepreneurs seek to establish a transgenerational enterprise—a firm that is skillfully managed to create long-term value and wealth for successive generations. These firms typically exhibit the same seven characteristics of successful transgenerational enterprises—a compelling vision, professionalized management team, a long-term ownership plan/strategy, effective communication, good corporate governance, a clear succession plan, and a comprehensive strategic plan. As a result of the need to ensure and evaluate successful creation of transgenerational wealth, many privately-held and family-owned businesses, particularly those that have survived multiple generational transfers, have instituted a policy of having an independent business appraiser/financial analyst conduct an annual valuation of the firm.

Many firms of various sizes and different phases of the corporate life cycle have recognized the benefits of having an annual valuation conducted. The most commonly cited benefits of an annual valuation policy include the following:

- **Accountability and Performance**—An annual valuation of a privately-held firm enables the shareholders to see the value that is being consistently created or destroyed by the management of the firm in its execution of the corporate strategic plan. Over time, if the executive management of the firm consistently fails to create value through the increase in the estimated fair market value of the company's shares, the shareholders may seek to replace the management team with a group more capable of executing the strategy and creating value for the shareholders. In addition, an annual valuation may enable the shareholders to identify the need for substantial change to the strategic plan if that plan consistently fails to create the level of value anticipated. Overall, the annual valuation promotes accountability and provides clear performance measurement.
- **Estate Planning Purposes**—Many shareholders in privately-held transgenerational enterprises have on-going estate planning strategies aimed at protecting wealth for heirs. As part of an estate plan, a shareholder may periodically place shares into a family limited partnership whose shares are then gifted to the shareholder's children. A shareholder may also make gifts of shares to the children each year for tax purposes. In order to facilitate this, an annual valuation of the privately-held enterprise provides the shareholders with part of the data necessary for these estate planning purposes.
- **Buy-sell agreements**—In multi-shareholder firms, a buy-sell agreement is an effective and practical means of establishing how the buyout of other shareholders will be conducted. Though many buy-sell agreements have a defined method or process for establishing the value of the firm's shares, an annual valuation sets a clear precedent for the methodology used to establish the value of the shares. For those firms that do not have buy-sell agreements in place, annual valuations are a good way of avoiding (or at least, tempering) disputes that may arise when a shareholder seeks to sell his shares to the other shareholders. Whereas one time valuations can be open to criticism of bias in favor of one party

or the other, an annual valuation tends to limit this accusation as the methodology has been applied consistently in previous years.

- **Promotes Effective Communication**—An annual valuation of a privately-held firm is an effective means of communicating value creation between the executive management, board of directors, and the shareholders of the firm. The valuation may be the catalyst for open discussion between the management and the shareholders on issues related to the strategic plan, succession plan, financial objectives, return expectations, etc. In addition, an annual valuation is a good way for the management and board of directors of the company to provide value-added services for the shareholders. This in turn can foster the creation of goodwill between the management of the firm and the shareholders, which may ultimately lower the firm’s overall cost of capital. The lower cost of capital may enable the firm to invest in value-creating projects that create long-term wealth for shareholders—projects that may have been overlooked in the past as a result of a higher cost of capital.
- **Facilitate Banking**—Many privately-held firms effectively utilize leverage to invest in value-creating projects. Often times, this leverage may exceed the credit available based on the firm’s fixed assets alone. In some cases, the financial institution may be willing to lend against the company’s goodwill, which is identified in the process of a formal valuation. The ability, then, of a privately-held firm to borrow based on the value of the goodwill or the value of the company’s shares may expand the universe of value-creating investment options available to the firm. In addition, the annual valuation may establish a track record of value creation which could be used to facilitate a recapitalization of the firm, enabling management to further seek value-creating projects, distribute funds to the shareholders via special dividends, etc.
- **Expands the Investment Options**—Privately-held firms, unlike publicly-traded counterparts, suffer from a lack of liquidity and the inability to use the company’s shares as currency when seeking acquisitions or mergers. An annual valuation that clearly establishes a trend in value creation may enable the management of the company to use the shares as acquisition currency for another privately-held company. The annual valuation is also beneficial in the shareholders’ investment decision making process with respect to maintaining the status of the company or seeking liquidity through a merger or sale of

the company. The history of annual valuations may provide the shareholders with a foundation for negotiation of more favorable deal terms.

- **Cost Benefit**—Annual valuations may also provide the company with cost benefits as compared to one-off valuations performed every few years. Many valuation firms charge reduced fees for the annual update to a valuation as part of an ongoing valuation process for a privately-held business. For example, suppose that Triumvirate Industries, a privately-held company with \$25 million in annual revenues, chooses to have a valuation performed once every five years. The valuation firm’s fee is set at \$20,000 per valuation. However, suppose that Triumvirate Industries has an annual valuation conducted. Whereas the initial valuation fee may be \$20,000, the subsequent annual updates are \$14,000. While the fee structure varies by firm and by project, annual valuation updates typically carry a lower cost than one-off valuations.

As can be seen from the previous discussion, there are a number of benefits associated with a privately-held firm instituting an annual valuation policy. While this is most typical with large, transgenerational enterprises, privately-held firms of all sizes may derive some benefit from annual valuations—whether it relates to financing purposes, estate planning, or the enlightenment of the owners in how they are creating value within their firm. Those firms that have been most successful in creating long-term shareholder value and transgenerational wealth have exhibited seven common characteristics, as previously discussed. Those firms that have instituted annual valuation policies have likely added value to the firm from one of the previous seven benefits. In the end, the best way of measuring the value that management has created for the shareholders of a privately-held business, particularly a transgenerational enterprise, is through annual valuations conducted by an independent valuation professional.