Entrepreneur & Family
BUSINESS COUNCIL

Business Valuations Overview

A High-Level Discussion of Business Valuation Concepts

Presented by Micah J. Vant Hoff, CPA, CVA, Principal at Cray Kaiser

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Presenter Intro

Micah joined the CK team in 2011 and became a Principal in 2020. Throughout his tenure at CK, Micah has led the completion of client engagements with a focus on closely-held and investor-backed businesses across a wide range of industries including construction, healthcare, logistics, technology, manufacturing, and others. His broad experience serves as the foundation for the assurance, accounting and tax services he provides to clients today. As one of the firm's Certified Valuation Analysts, Micah also advises clients on matters of business valuation, business sales and acquisitions, and transition.

Micah is a member of the American Institute of Certified Public Accountants (AICPA), the Illinois CPA Society (ICPAS), and the National Association of Certified Valuators and Analysts (NACVA).

Why is business valuation so important – even for new business owners?

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Concepts

- **Common Valuation Triggers**
- **Business Valuation Defined:**
  What is business valuation and what are the key inputs?
- **The “Why”: Standards of Value**
  The purpose of the valuation determines which standard of value is used.
- **The “How”: Valuation Approaches**
  Different valuation approaches and methods exist, and selection of one (or multiple) depends on company characteristics.
- **Valuation Discounts**
- **Key Valuation Drivers**

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Common Valuation Triggers

- Succession or exit planning
- Contemplated sale or acquisition
- Gifting and estate planning or administration
- Divorce or shareholder dispute
- Debt or capital infusions
- Buy-sell agreements
- Others

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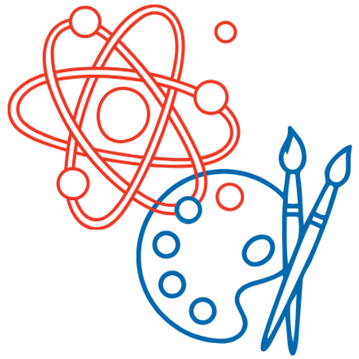
Business Valuation Defined



An art and a science = objective methods, subjective judgments

The value of a business:
typically considered to be the **present value of the future benefits** to be received from the business, discounted for risks to achieving those benefits

- Future benefits = future cash flows
  - Future sale of ownership interest (or recapitalization)
  - Periodic distributions from business
  - Owner's discretionary cashflows (for controlling ownership interest in a small business)
- Present value – calculated using discount rate which takes into account risk factors and expected growth

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Business Valuation Defined (con.)

Risks to achieving future cash flows:

- Typically captured in the discount rate – higher rate = higher risk
- Economic outlook uncertainties
- Competitive environment in industry
- Declining demand/technical obsolescence
- Regulatory risks
- **Company-specific risks:**
    - High degree of leverage
    - In a declining industry
    - Management concentration
    - Labor scarcity or disputes
    - Customer concentrations
    - Sole supplier situations

Example – Risk Factors

Which company carries greater risk?

Company #1

4M Orthodontic Solvents

From industry reporting:
“New technology poses a significant threat to the industry, as do-it-yourself dental products such as SmileDirectClub and Invisalign offer consumers teeth aligner kits they can order and use at home, without visiting an orthodontist. As the technology improves, it will become more difficult for industry supply companies to compete with more affordable and convenient options.”

Company #2

Sedona HVAC

From industry reporting:
“Significant long-term growth is projected for the industry due to factors including population expansion, greater climate extremes, and strong commercial and residential construction trends.”

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Example – Risk Factors

Which company carries greater risk?

Company #1

TOP FIVE CUSTOMERS

HenDrik Supply - $25,000,000 annual revenues

Customer	Annual Sales	% of Total Sales
Prairie Recycling	$ 11,745,000	47.0%
H.E. Mathis	$ 4,755,250	19.0%
Maycliff Company	$ 1,589,775	6.4%
Charleston Center	$ 978,500	3.9%
BC Outdoors	$ 951,850	3.8%
	$ 20,020,375	80.1%

Company #2

TOP FIVE CUSTOMERS

T.J.'s Supply Co. - $25,000,000 annual revenues

Prairie Recycling	$	1,745,500	7.0%
H.E. Mathis	$	851,350	3.4%
Maycliff Company	$	772,000	3.1%
Charleston Center	$	652,550	2.6%
BC Outdoors	$	475,000	1.9%
	$	4,496,400	18.0%

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The “Why”: Standards of Value

Determined by the Valuation Purpose

- **Fair Market Value: IRS Revenue Ruling 59-60**
  - Used in all federal tax matters (gift, estate, inheritance, and income tax)

- **Fair Value: Statutory definition**
  - Can vary by state or jurisdiction, typically used in shareholder disputes

- **Investment Value: Value to a specific buyer**
  - Strategic value to a specific investor based on individual investment objectives and expectations
  - All other things being equal, a business may be worth more to another industry participant or investment company than to a hypothetical willing buyer because of:
    - Cost efficiencies to be gained (eliminating redundant costs, finding synergies)
    - Vertical integration
    - Potential for cross-selling
    - Strategic market expansion – new geography or product/service
    - Other reasons
  - Often seen in private equity roll-ups

Standards of Value – Hypothetical Illustration

		Company A		
		Fair Market Value	Fair Value	Investment Value
Projected earnings		850,000	850,000	1,200,000
Capitalization rate		19.5%	19.5%	16.0%
		4,358,974	4,358,974	7,500,000
Marketability discount	15%	(653,846)	-	-
Indicated value		3,705,128	4,358,974	7,500,000

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The “How”: Valuation Approaches

Three Primary Approaches:

- **Asset Approach**
- **Market Approach**
- **Income Approach**

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Asset Approach – Focus on Balance Sheet

- Values a business based on the value of its net assets (assets less liabilities)
- Typically used for asset-heavy companies or liquidation scenarios
- Not typically most suitable for profitable going concerns

Example – Asset Approach

	12/31/2024
Cash	2,766,174
Accounts Receivable	8,436,153
Inventory	10,874,981
Prepaid Expenses	785,475
	22,862,783
Fixed Assets - Cost	57,822,239
Accumulated Depreciation	(49,145,497)
Net Fixed Assets	8,676,742
Intangibles	620,749
Total Assets	32,160,274

	12/31/2024
Line of credit	2,850,000
Accounts payable	5,405,928
Accrued payroll	944,319
Current portion of LTD	1,850,000
	11,050,247
Long-term debt	1,250,000
Total Liabilities	12,300,247
Common stock	75,000
Retained earnings	19,785,027
Total Equity	19,860,027
Total Liabilities and Equity	32,160,274

	Year Ended 12/31/2024
Net Sales	59,029,672
Cost of Sales	48,934,465
Gross Profit	10,095,207
Operating Expenses	9,050,071
Operating Income	1,045,136
Interest Expense	(50,460)
Other Income	59,787
Pre-Tax Income	1,054,463
Income Taxes	(184,531)
Net Income	869,932

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Market Approach – Comparison to Other Transactions

Methods:

- **Public company guideline method**
    - Uses publicly available information for comparison

- **Private company transactions**
    - Uses information as reported in databases such as BIZCOMPS and DealStats

- Relies on available data from comparable companies and transactions
- Requires industry knowledge and judgment

Example – Guideline Public Company Method

Challenge: How comparable are the public companies being used?

	EV/EBITDA
Emcor Group, Inc. (EME)	15.1
Comfort Systems USA, Inc. (FIX)	18.7
Quanta Services, Inc. (PWR)	18.8
Average	17.5

ECDC Mechanical Contracting

EBITDA	$	1,500,000
PCG multiple		17.5
Calculated enterprise value	$	26,300,000
DLOM 15%	$	(3,945,000)
Calculated value post DLOM	$	22,355,000

	Emcor Group, Inc.	ECDC Mechanical Contracting
Revenues	12,583,000,000	27,957,000
EBITDA	996,000,000	1,500,000
Employees	40,400	110
Locations	180	1
52-week stock price range	$151.52 - $354.73	N/A

Other considerations:

- Service offerings?
- Board of directors and management team vs. owner/operator?
- Access to credit markets?
- Access to new markets?

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Example – Private Company Transactions Method

Transaction ID	SIC	NAICS	Business Description	Location (City, State or Region)	Annual Gross Sales ($000's)	Sale Date	SDE ($000's)	Sale Price ($000's)	Ask Price ($000's)	SDE/Annual Gross	Sale Price/Annual Gross	Sale Price/SDE	Percent Down	Terms on Outstanding Consideration	Inventory Amount ($000's)	FF&E ($000's)	Rent/Annual Gross	Days On Market	Number Of Employees
15783	8711	541330	Site Development	Florida	$1,339	05/15/2022	$460	$725	$975	34.4%	0.54x	1.58x	100.0%		$0	$250	4.0%	356	3 FT/1 PT
16103	8711	541330	Soil Engineering	Florida	$1,007	04/15/2022	$559	$915	$915	55.5%	0.91x	1.64x	10.0%	10 Yrs @ 5.5%	$0	$85		255	7 FT/2 PT
15784	8711	541330	Site Development	Florida	$8,210	02/28/2022	$3,360	$2,900	$2,900	40.9%	0.35x	0.86x	100.0%		$0	$950	3.0%	273	10
14319	8711	541330	Engineering Service	Wisconsin	$678	12/29/2021	$299	$250	$599	44.1%	0.37x	0.84x	100.0%		$1	$50			3 FT/2 PT
15785	8711	541330	Engineering-Construction	Florida	$1,119	07/01/2021	$652	$1,100	$1,150	58.3%	0.98x	1.69x	100.0%		$0	$50	3.0%	125	8
14320	8711	541330	Civil Engineering	Florida	$1,309	05/27/2021	$416	$1,064	$900	31.8%	0.81x	2.56x	52.0%	10 Yrs @ 6.5%	$0	$200	6.0%	441	17 FT/2 PT
14321	8711	541330	Architecture Services	Montana	$738	04/30/2021	$179	$280	$280	24.3%	0.38x	1.56x	18.0%		$0	$21			5
14322	8711	541330	Civil Engineering	New Jersey	$384	04/16/2021	$92	$135	$150	24.0%	0.35x	1.47x	26.0%		$0				4
14323	8711	541330	Engineering Service	Florida	$1,889	03/31/2021	$687	$940	$740	36.4%	0.50x	1.37x	100.0%		$10	$236	1.0%	505	8
14324	8711	541330	Civil Engineering	Florida	$1,546	03/22/2021	$730	$1,250	$1,600	47.2%	0.81x	1.71x	88.0%		$0	$60	3.0%	777	11
14581	8711	541330	Civil Engineering	Florida	$1,546	03/22/2021	$487	$1,250	$1,600	31.5%	0.81x	2.57x			$0	$60	3.0%	777	8
12984	8711	541330	Engineering Services	Turlock, CA	$1,404	03/19/2021	$273	$850	$1,400	19.4%	0.61x	3.11x	100.0%		$0				
14325	8711	541330	Environment Lab	Florida	$1,403	02/11/2021	$228	$544	$544	16.3%	0.39x	2.39x	54.0%	3 Yrs @ 10%	$1	$350	1.0%	1346	2
14326	8711	541330	Engineering Services	South Dakota	$3,542	12/30/2020	$1,566	$3,200	$3,250	44.2%	0.90x	2.04x	11.0%	10 Yrs @ 5.75%	$25	$5			2 ft/2 PT
13315	8711	541330	Civil Engineering	Florida	$2,236	11/23/2020	$450	$1,450	$1,350	20.1%	0.65x	3.22x	19.0%		$0	$400	2.0%	482	19
13068	8711	541330	Engineering/Consulting	Florida	$2,052	10/15/2020	($18)	$1,500	$1,750	(0.9%)	0.73x		80.0%	10 Yrs @ 8.3%	$0	$941	5.0%	26	24
12990	8711	541330	Engineering Services	Walnut Creek, CA	$2,252	09/25/2020	$768	$638	$1,600	34.1%	0.28x	0.83x	100.0%		$0				
14327	8711	541330	Engineering Services	Texas	$3,933	09/25/2020	$734	$944	$2,300	18.7%	0.24x	1.29x	69.0%	3 Yrs @ 0%	$4				10 FT/1 PT
13430	5999	541330	Retail-Spa Covers	Auburn, CA	$471	09/02/2020	$92	$120	$129	19.5%	0.25x	1.30x	0.0%		$0				
13290	8711	541330	Engineering/Consulting	Florida	$1,168	04/13/2020	$327	$700	$700	28.0%	0.60x	2.14x	21.0%	10 Yrs @ 7.8%	$0	$25	6.0%	562	5 FT/1 PT
13103	8711	541330	Civil Engineering	Florida	$1,037	01/30/2020	$368	$900	$900	35.5%	0.87x	2.45x	72.0%	5 Yrs @ 9%	$0	$25	9.0%	85	5 FT/1 PT
12596	8711	541330	Electrical Engineering	Florida	$587	11/15/2019	$249	$140	$199	42.4%	0.24x	0.56x	100.0%		$40	$154	2.0%	666	5
12373	8711	541330	Environmental Consult	Florida	$1,063	04/27/2019	$734	$2,250	$2,000	69.0%	2.12x	3.07x	67.0%		$0				2 FT/9 PT

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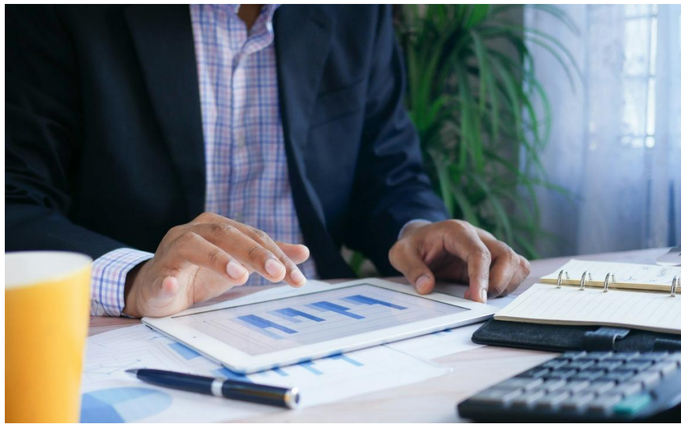
Income Approach – Expected Cash Flows from Investment



- Derives value of business based on expected future benefit stream
- Useful for valuation of small businesses as:
  - asset methods often do not reflect earnings potential
  - sufficient information often is not available for use of market methods
- **Two Methods:**
  - **Capitalization of Earnings:** Stable businesses with predictable earnings and mature growth rate
  - **Discounted Cash Flow (DCF):** Significant growth or change expected in earnings stream
- **Key inputs:** Cash flows and discount rate

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Income Approach – Key Input #1: Cash Flows

- Analysis of earnings for trends and potential normalization adjustments required

- **Normalizing adjustments**
  - Changes made to a company's financial statements to present a clearer picture of its true economic performance
  - **Purpose:**
    - to reflect operations as if company was professionally managed, and
    - to remove any non-recurring, non-operating, or owner-specific items that distort the sustainable earnings stream
  - Use of the income and market approaches requires a normalized earnings stream
  - Company's net assets (balance sheet) are also reviewed for potential normalizing adjustments

Income Approach – Key Input #1: Cash Flows

Common income statement adjustments:

- Non-operating income (investment income, gain/loss on sale of assets, PPP loan forgiveness, etc.)
- Non-recurring expenses (one-time litigation costs, losses from one-time write-downs, etc.)
- Accounting method differences (ex. accelerated tax depreciation used for book purposes, tax inventory adjustments)
- Discretionary expenses (charitable contributions, personal auto expenses, etc.)
- Related party rents (could be above or below market)
- Owner compensation and benefits (could be above or below market)
- Income taxes – tax affect earnings and consider tax impacts of other adjustments

Income Approach – Key Input #1: Cash Flows

Common balance sheet adjustments:

- Non-operating assets or liabilities (excess working capital, personal use assets, loans to fund treasury stock purchases, etc.)
- Intangibles (goodwill from previous transactions, etc.)
- Inventory – write off any obsolete or unsalable inventory, adjust to replacement cost if reported at different value
- Fixed assets – adjust to fair market values
- Income taxes – recognize tax impacts for projected capital gains in assets held

Example – Normalizing Adjustments

Example 1

	Year Ending December 31, 2024	Year Ending December 31, 2023	Year Ending December 31, 2022	Year Ending December 31, 2021	Year Ending December 31, 2020
Net Income per Income Statement	8,879,601	7,064,983	6,710,644	6,373,036	5,319,143
Inventory adjustment	(123,417)	14,631	64,593	(12,988)	(45,667)
Depreciation	3,912	7,823	15,769	27,730	23,757
Owners' compensation	(1,043,293)	244,515	603,519	683,570	609,675
Interest from non-operating cash	(43,094)	(36,314)	(3,736)	(3,604)	(3,079)
Gain (loss) on sale of equipment	(2,500)	-	(9,138)	38,437	-
PPP loan forgiveness income	-	-	-	(1,450,000)	-
Provision for income taxes	(1,037,213)	(1,002,544)	(1,020,421)	(729,646)	(815,835)
Net Income - Adjusted	6,633,996	6,293,094	6,361,230	4,926,535	5,087,994

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Example – Normalizing Adjustments

Example 2

	Year Ending June 30, 2024	Year Ending June 30, 2023	Year Ending June 30, 2022	Year Ending June 30, 2021	Year Ending June 30, 2020
Net Income per Income Statement	19,497	165,911	90,637	(125,197)	127,331
Warehouse sublease income	(1,250)	(15,000)	(15,000)	(15,000)	(15,000)
Interest income	(6,494)	(12,597)	(7,553)	(7,171)	(6,137)
Bad debt expense	-	-	176,264	-	-
Owner compensation	358,500	344,000	650,000	287,500	295,000
Gain (loss) on sale of equipment	-	(6,328)	-	-	-
Rent expense	110,000	110,000	110,000	110,000	110,000
Provision for income taxes	(105,219)	(142,850)	(284,587)	(56,852)	(128,752)
Net Income - Adjusted	375,034	443,136	719,761	193,280	382,442

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Income Approach – Key Input #2: Discount Rate

- **Key Input:** Discount rate

- Commonly used approach to develop the appropriate discount rate:
  Build-up method
  - Applicable discount rate is composed of identifiable risk factors
  - **Risk-free rate:** US government debt (long-term treasury bonds)
  - **Equity risk premium:** extra return required for investment in equities vs. risk-free investments
  - **Size premium:** extra return required for investment in small cap stocks as compared to large cap stocks
  - **Company-specific risk premium:** includes factors such as industry, lack of diversification, customer concentration, lack of management depth, and other risks specific to company
  - To get to capitalization rate, subtract expected growth rate

Small Company Stocks	16.1%
Real Estate Investment Trusts	12.7%
Large Company Stocks	12.2%
Long-Term Corporate Bonds	6.4%
Long-Term Government Bonds	5.6%
U.S. Treasury Bills	3.3%

Measure	Value
Risk Free Rate (RFR)	4.86%
Equity Risk Premium (ERP)	6.71%
Size Premium (SP)	7.12%
Industry Risk Premium (IRP)	1.00%
Company Specific Risk Premium (CSRP)	3.00%
Cost of Equity (CoE)	**22.69%**

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Example – Income Approach

Details:

- Projected earnings stream determined to be $5,720,147 per year
- Discount rate calculated to be 21.5%
- Sustainable growth rate determined to be 3.0%
- Capitalization rate is equal to discount rate minus sustainable growth rate (21.5% - 3.0% = 18.5%)
- Analysis of balance sheet indicates $7,221,146 in excess working capital held by the business
- Dividing the projected earnings by the capitalization rate and adding back non-operating assets yields the indicated value

Projected Earnings	5,720,147
Capitalization Rate	18.5%
Operating Value	30,919,712
Non-operating assets	7,221,146
Indicated value (marketable, controlling)	38,140,858

Valuation Discounts (Fair Market Value)

- Rational investors will pay less for an ownership interest that is non-controlling vs. a controlling stake
- Rational investors will pay less for an ownership interest that is harder to sell
- Level of discount applicable to a specific valuation varies based on a number of factors
- Calculated using data including various long-run studies and tax court cases

Discount for Lack of Control (DLOC)

- **Concept:** level of control in an ownership interest affects value
- Control impacts the ability of an owner to influence future cashflows attributable to the ownership interest
- Market data and studies show non-controlling interests trade at a discount to controlling interests

Reasons for DLOC – non-controlling owner can't:

- Appoint management/directors
- Set compensation for management/ownership
- Set operational policy
- Acquire or liquidate assets
- Select vendors
- Acquire other companies/set growth strategy
- Make decisions on company leverage
- Pay dividends or distributions
- Change the bylaws or operating agreement
- Block actions taken by controlling owner

Discount for lack of marketability (DLOM)

- **Concept**: significant impediments to liquidating an ownership interest will impact the value of that interest

Risks associated with a potential sale of a nonmarketable interest:

- Uncertain time horizon (could be months or even years to liquidate)
- Costs to prepare for and execute a sale
- Risk as to eventual sale price
- Potential for deferred proceeds structure
- Inability to borrow against estimated value of stock

Factors that increase/decrease size of marketability discount:

- Financial statement analysis
- Company dividend policy
- Nature of company, history, industry position, economic outlook
- Company management
- Amount of control in transferred shares
- Restrictions on transferability
- Holding period for stock
- Company redemption policy
- Costs associated with a public offering

Example - Valuation Discounts

- **Concept:** an illiquid, noncontrolling interest in a closely held business is often worth significantly less than a controlling, marketable interest

Indicated Value at March 31, 2025		$ 7,021,640
Less: Discount for lack of control	25%	(1,755,410)
		$ 5,266,230
Less: Discount for lack of marketability	20%	(1,053,246)
		$ 4,212,984
Number of shares outstanding		800,000
Calculated value per share of a non-controlling ownership interest		$ 5.27

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Key Valuation Drivers

- Revenue growth and predictability
- Profit margins and cost control
- Customer concentration
- Recurring vs. one-time revenue
- Management team depth
- Industry and market conditions
- Competitive advantages/size of moat
- Performance vs. peers and industry
- Other risks and risk mitigating factors

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For more information: https://craykaiser.com/business-valuation/