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Learning Series - #22

Making sense of the Business Valuation Essentials for Underwriters

Business valuation is a complex and challenging skill that requires underwriters to provide an opinion of the value of an asset or ownership interest when evaluating buy-sell agreements, debt and financing arrangements, company re-organisations or even personal estate tax planning where a business is a major asset in the estate. The fair market value (FMV), the current value that a willing and knowledgeable buyer will pay for a business, is most used to assign a value to a business interest.

The FMV changes over time as it is impacted by multiple factors that must be considered: economy and industry outlook, nature and financial health of the business, earnings and dividend-paying capacity, value of goodwill (intangibles such as brand recognition, reputation, customer loyalty, location, quality of management and workforce, intellectual capital), size of business interest (majority vs. minority) and market price of comparable public company stocks. If available, a recent professional valuation report should be reviewed as it will consider these factors and will likely be more extensive than an underwriting estimate. A reasonably comparable company or property recently sold can also provide a useful estimate.

It is also important to keep in mind that whereas large publicly traded corporations seek to maximize profits as their value rely on their stock, smaller businesses that operate outside the stock market seek to minimize profits for tax savings purposes. Therefore, to conceal profits, financial statements can include inflated and personal expenses such as excessive salaries, personal travel expenses, personal insurance, personal property taxes and loans to owners of the business. Extraordinary expenses or income (expenses from a natural disaster, sale or purchase of operating assets, receipt of life insurance death benefits, etc) can also have a short-term effect on net income. Whether unrealistically deflating or inflating net income, underwriters should carefully review the financial statements and make appropriate corrections in order to have a more accurate financial picture under “normal” conditions.

Capitalization of Earnings

This method of valuation is based on the concept that a business has value only to produce profits and it attempts to quantify those future earnings. It works by multiplying the average net income by a factor representing the return an investor might expect from investing in this business. This method is preferred for non-asset intensive (i.e service companies, retailers, distributors) and established businesses (minimum three years of existence) with a reasonable predictable operating history.

For professional service businesses (dental, medical, accountants, legal, restaurants, hotels, architects, garages, etc), a factor between 1 and 1.5 of gross revenue can be used as an alternative valuation method. The higher factor is more suitable for businesses with stable revenue and significant equity. These entities are mainly acquired for the value of their existing customers.

Type of Business	Investment Return	Factor
Well established and stable Predictable future Significant assets Low risk/moderately competitive industry	8-10%	10-12x
As above but medium risk/very competitive industry Cyclical business cycle	11-15%	7-9x
Limited assets Small but experienced Highly competitive business	16-20%	5-6x
Small with limited expertise Large without predictable/stable profits	21-25%	4-5x
Personal services/single owner High risk/changing industry	26-30%	3-4x

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Making sense of the Business Valuation Essentials for Underwriters (cont'd)

Discounted Future Earnings

This method is best suited for valuing new businesses without a track-record of earnings. It is similar to the capitalization of earnings method but uses projected future earnings (minimum five years) that are discounted to their present value by using a factor that represents a rate of return an investor might expect from investing in a business with a comparable risk. This approach is more speculative and optimistic projections should be reviewed with caution as most start-ups fail within five years.

Simplified example of start-up AAA Inc. that resembles BBB corp which pays 10% dividend on its stock:

Time	Year 1	Year 2	Year 3	Year 4	Year 5
Profit Forecast	-\$200,000	-\$25,000	\$75,000	\$200,000	\$250,000
Discount	.90 (10%)	.81 (.9x.9)	.73 (.9x.9x.9)	.66 (.9x.9x.9x.9)	.60 (.9x.9x.9x.9x.9)
Current Value	-\$180,000	-\$20,250	\$54,750	\$132,000	\$150,000

Value of AAA Inc. today: (150,000 + 132,000 + 54,750 – 20,250 – 180,000) = \$136,500

Without financial data, underwriters should put even greater emphasis on the value of human capital when reviewing young companies. Experienced management with a track record of success and highly skilled employees will significantly increase the company's potential for continued survival and success.

Adjusted Book Value

For asset-intensive businesses (i.e manufacturers, farms, real estate development firms, holding companies), rather than focusing on income, this method involves finding the current FMV of a company's assets and liabilities (historical cost on financial statements). For underwriting assessment purposes, a quick online search for recent municipal values of real estate properties or plants, production quota for farms or using Google maps/street view to assess a location (key factor in valuation) can be sufficient.

Price to Earnings Method

For closely held businesses such as a family-owned business where shares are not traded publicly, the price to earnings (P/E) ratio of a similar publicly traded company (or several) can be applied to the earnings of the business to produce a valuation estimate. P/E ratios can be found on Yahoo Finance.

Simplified example: Closely held ABC corp had a net income of \$500,000 last year and similar publicly traded companies have a P/E ratio of 3:1. Its value can therefore be estimated as 3 x \$500,000 or \$1,500,000.

Underwriting Considerations

- Companies have good and bad years for many reasons. If fluctuating, recent results should be averaged and at least 3 years of financial results should be obtained for most business cases.
- A general understanding of the risk is important. What is the business, what are they offering? Is it a new product/service and is it viable? As consumers, we can also use our instinct when assessing new products.
- Regardless of financial results, an adequate insurable interest (buy-sell, key person, long term loans) must be established. A potential financial loss experienced by the beneficiary is essential to every application.
- The final "notes" section of financial statements should be obtained as it contains valuable information such as sources of revenue, equipment worth, comments on financial risks, legal action against the company, related companies, loans and their terms, extraordinary events, etc.
- Although not an exact science, selecting the appropriate valuation method or comparing multiple ones depending on the nature of the business will help achieve a more accurate estimate. Service oriented businesses mainly producing a predictable income will be more suitable for earnings methods whereas businesses focused on holding assets/investments or with unpredictable earnings will favor book value (assets minus liabilities) or adjusted book value methods.