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Quantifying Transferable Enterprise Value in Small to Medium Size Enterprises (SMEs)

The Value Driver Methodology

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Introduction

Enterprise value measures the "true worth" or "economic value" of a business. More specifically, it is a measure of the actual takeover price that an investor would have to pay in order to acquire a particular firm.[1] To calculate enterprise value, investors and buyers look 'under the hood' of a business and analyze the operations or 'business engine', typically as part of a due diligence process. However, how much (if any) of that value is transferable is determined largely by whether the business can dependably generate revenue and profit at or above its current rate, even without the current business owner(s) in charge.

Although there have been numerous approaches to measure the effectiveness of the operations in a private business, these methods are often ad hoc, qualitative, and delivered via consulting practices or advisory services, making them expensive for many SMEs. And while calculating enterprise value is an essential part of the business transfer process, there is currently no systematic approach for quantifying the intangible value drivers in a private business based on a common framework and set of standards (akin to GAAP in accounting), with enterprise value as the 'yardstick' and dollars the unit of measure.

This white paper outlines a new framework and methodology to quantify transferable enterprise value in SMEs. This methodology provides actionable transparency to the operations of a private business - an often missing yet critical component in financial valuations - to enable companies to improve value, communicate among owners, boards, and management teams, and successfully transfer to new owners.

Value Driver Methodology

Private Business Standards

In 2009, consulting firm Chairman's View, Inc., creators of CoreValue® [2], pioneered a complete set of Private Business Standards (PBS) for a well-run private business, irrespective of industry. These standards, vetted by academics and industry experts and modeled after due diligence check lists, are built on a framework of 18 market and operational value driver categories - generally regarded as 'intangibles' - by which private companies can be measured to determine enterprise value.

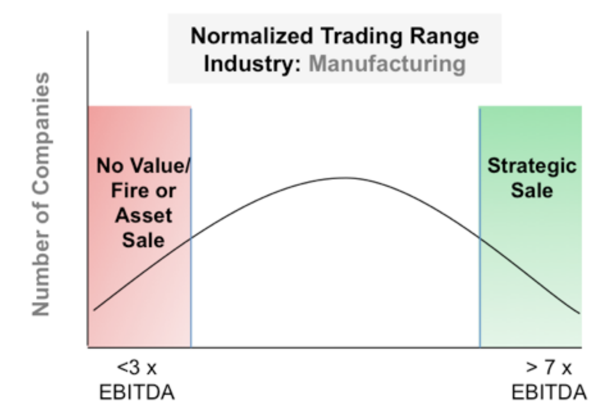
Value Driver Framework and CoreValue® Rating

With a framework of value drivers based on a set of standards, one can begin to isolate and measure a company's capabilities and strength within each individual value driver category. CoreValue® uses the Value Driver Methodology to assess a private company across 18 value drivers based on hundreds of detailed questions and objective criteria. Algorithms quantify the value of each driver and of individual components within each driver. Eventually, these calculations roll-up to a single number on a 0-100 scale, called the CoreValue® Rating. The higher the CoreValue® Rating, the stronger the 'business engine' and the more likely it can transfer successfully.

CoreValue® Enterprise Value Calculation

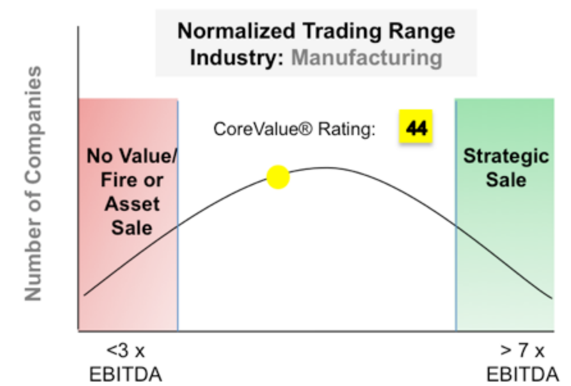
CoreValue® enterprise value is a measure of *transferable* enterprise value. It is based on a company's CoreValue® Rating, industry, annual revenue, adjusted EBITDA, and profit margin. Many financial valuation methodologies identify a value range for companies based on their industry and past financial performance (revenue and profit). CoreValue® refines this computation to include measures of transferable value expressed as the CoreValue® Rating while making accommodations for profit margins outside industry norms.

Standard valuation computations are typically based on a range of high and low industry-specific multiples of either revenue or adjusted EBITDA. These multiples capture the expected range of values for a company in a normal sale. This value range excludes abnormally low (fire sale) or exceptionally high (strategic buy) transactions.



While financial valuation methodologies identify a value range for companies based on their industry and past financial performance, the price at which they will be transferred cannot be reliably predicted based on their past financial performance alone. In the narrowest statistical sense, a value at the middle of this range provides an accurate assessment of the price at which a business will be transferred. That is to say, it represents a best guess of the selling price, in the absence of any additional information. However, the actual transferable enterprise value of any business may be significantly higher or lower than the middle value. Typically, the high and low ends of traditional rule-of-thumb valuation ranges differ by a factor of two. The CoreValue® enterprise value calculation seeks to improve the accuracy and reduce the variance of traditional financial valuation methodologies.

The CoreValue® enterprise value calculation takes into account operational and market data (CoreValue® Rating), to situate a particular company's enterprise value within the normal trading range for a company in its industry, based on its financial performance.



Secondly, while a value range provided by standard financial valuations is a useful rule of thumb for many companies, it fails to take into account companies whose margins are different from their industry norms. For instance, they tend to undervalue growth companies in EBITDA-based valuations. To address this issue, the CoreValue® algorithm first computes the accepted industry standard value range based on empirically determined high and low multiples and the normal industry multiplier (revenue or EBITDA). The company's margins are then compared to the industry averages, and if the margins are significantly different from industry norms, then an alternate value range is computed based on those margins. These two ranges are then merged to produce an Adjusted Value Range based on the two measures.

The CoreValue® enterprise value calculation takes into account operational and market data, expressed as the CoreValue® Rating, to situate a company's enterprise value within the high and low trading ranges for its industry.

The CoreValue® Rating is then used to interpolate the enterprise value within the Adjusted Value Range of the company. The higher the CoreValue® Rating, the higher the company's transferable enterprise value within the Adjusted Value Range. Since the CoreValue® Rating is standards-based and empirically scored, the rating effectively ranks the assessed company relative to its industry peers, and adjusts the enterprise value based on that ranking.

CoreValue® Confidence Range

Numerous factors can affect the accuracy and precision of the CoreValue® enterprise value calculation. For example, the company may have lower than average profit margins in an industry in which valuations are generally based on sales volume. Furthermore, within the operations of a company, there can be serious issues or ‘red flags’ that can negate all the value in a business, rendering it virtually non-transferable to new owners.

Common issues include: unresolved legal issues or environmental liabilities, a stagnant or declining market niche, or the value of the business is in the business owner, not the operating business. The CoreValue® Confidence Range identifies these issues and provides an indication of the variance, or uncertainty, that a company could be transferred at the assigned enterprise value calculation.

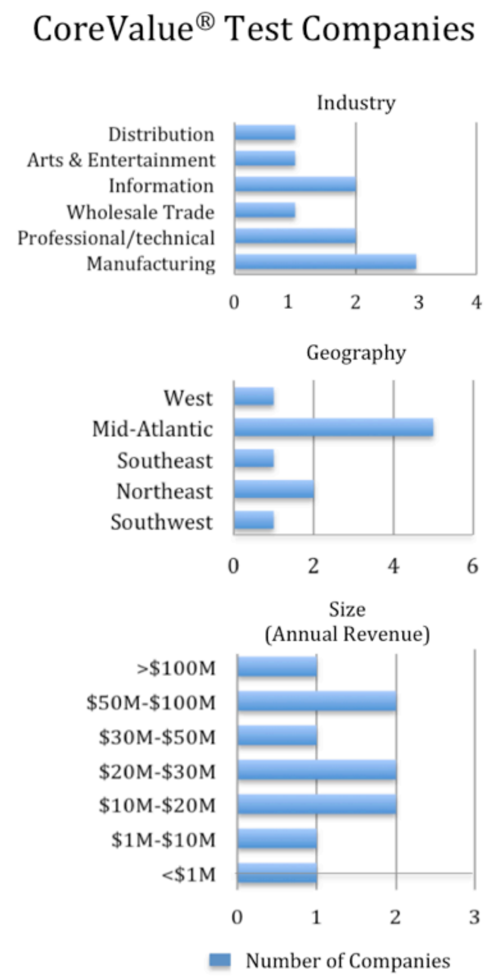
To date, the CoreValue® enterprise value estimate generated by the Value Driver Methodology is consistent with enterprise value calculations generated by traditional financial valuation methodologies.

Value Driver Methodology Compared to Financial Valuation Methodologies

Business Valuation Center, LLC (BVC)[3], a leader in private business valuation, conducted a test of the Value Driver Methodology and found that this methodology generated enterprise value estimates consistent with financial valuations.

Testing Methodology: Sample Companies

Ten private companies that had financial valuations completed in the past 12 months, were selected randomly from a sample of 5,000. Each of the ten companies also completed a CoreValue® assessment. The companies represent a cross section of industries, size, and geography.



Testing Methodology: Financial Valuation Methodology

Each of the 10 companies had a financial valuation conducted within the past 12 months by BVC. Three methodologies were used and weighted to derive the enterprise value calculation as follows: Private Guideline Company Method (25%), Public Guideline Company Method (25%), and Discounted Cash Flow (50%).

Test Results

In all 10 test cases, the enterprise value calculation generated by the financial valuation methodology fell within the CoreValue® Confidence Range for the CoreValue® enterprise value estimate. In over half the cases, the estimates generated by both methodologies fell within 10% of each other.

Company	CoreValue® Enterprise Value ($)	BVC Enterprise Value ($)	Difference	CoreValue® Confidence Range
1	11,900,000	13,900,000	-14.4%	<50%
2	237,000	231,000	2.6%	<50%
3	5,950,000	7,131,113	-16.6%	50-70%
4	11,600,000	11,445,714	1.4%	50-70%
5	9,730,000	12,686,439	-23.3%	50-70%
6	3,520,000	3,294,000	6.9%	50-70%
7	166,000,000	201,187,444	-17.5%	70-90%
8	92,200,000	106,039,815	-13.0%	70-90%
9	86,200,000	89,536,000	-3.7%	70-90%
10	33,100,000	33,444,000	-1.0%	>90%

BVC and CoreValue Enterprise Value calculations are exclusive of cash on the balance sheet.

Conclusion

While the market is the only perfect method of determining enterprise value, there is a growing need for an objective, accurate, actionable, and affordable measure of enterprise value for SMEs, well before a company needs to sell. The Value Driver Methodology not only provides an objective assessment of a company's transferable enterprise value consistent with the output of financial valuation methodologies, but this methodology also *quantifies the individual drivers of value*. With quantifiable transparency into the operations of a company based on a common framework and set of standards, CEOs, business owners, boards, banks, and other stakeholders can better understand the relative strengths and weaknesses of a private company, communicate effectively, deploy capital, and measure return on investment with transferable enterprise value as the 'yardstick' and measure of business success. Ultimately, a strong business engine with transferable enterprise value can thrive well beyond its current ownership and transfer to a new generation, thereby preserving jobs and providing a strong foundation for future growth.

[1] *Business: the ultimate resource*. New York: Basic Books, 2006. Print.

[2] CoreValue® is a patent-pending web application.

[3] Since 1986, Business Valuation Center, Inc. has conducted more than 5,000 valuations of private companies across a range of industries and has served as the primary valuation advisor for the U.S. Small Business Administration (SBA) from 2005-2010.