

Business Valuation, an Analysis of Risk

By: George D. Abraham, Business Evaluation Systems, CEO and Chief Appraiser

Analyzing risk is the predominate factor in valuing a business. The appraiser must analyze every aspect of the business and quantify his or her analysis of the company's risk into value. A study of the significant risk factors in the business must be identified and then rated as to the degree of risk each carry. The following are some of the factors to analyze in a business.

Labor

There are many key factors to analyze as far as labor is concerned. Are employees hard to find? What educational skills or level is required and is the labor pool such that they could be replaced? If the company is highly technical, there may not be many individuals in the area that have those skills and thus make it difficult for the company to grow. On the other hand, many of these companies can outsource or use virtual offices with employees in any part of the country.

Are key employees and management due a significant salary increase? Again, many employees are faithful to the owner and feel that once the company grows a little more, they will be rewarded both in salaries and advancement.

What are the ages of the employees and key management? If many of the key managers are close to retirement age, they may just retire when ownership changes. After many years on the job and very close to retirement, many in management don't want the changes they perceive with new ownership.

What is the liability risk with the employees? Are the jobs they are performing such that accidents are a normal occurrence in the industry? If this is the case, have the employees been trained sufficiently in safety procedures? Is safety an on-going program for the employees? If the company has delivery vehicles, a check of the accident history is in order.

Management

Will key employees' stay once the company changes ownership? It is not uncommon for key employees to leave the company for a more lucrative position with a larger competitor. Many times, the key employees stay with the company as they are close to the owner and are in a position to contribute to the company's growth and success and feel they will be rewarded heavily someday.

Has management been efficient? Are they up to the challenges of the future? Many companies have employees that grew up with the business but now the company has outgrown them. They do not have the education or expertise to take the company to the next level.

How many of the key managers are relatives? If all or most of the key managers are relatives, and will be gone after the company sells, there is no management.

Who is responsible for the majority of sales? Does the company have a sales force or is the owner responsible for most of the sales and if so, how hard would it be to replace him.

Financial Strength

Is the company solid or are they in a cash crunch? Some ratio analysis can tell you what kind of financial position the company is in and how it compares to other companies in its industry. An analysis of the company's account receivables is necessary to see how they are getting paid. An abundance of slow paying customers can drain the company's working capital. Insufficient working capital can prohibit the company from growing because it can't buy enough raw materials or inventory to meet an increase in sales.

Does the company have the ability to buy from several suppliers or are they enslaved by one that can raise prices whenever they want? Another question that pops up is how stable is the supplier? The cost of sales is usually the largest expense for a company. If you have no idea what the future costs are going to be, you can't make any kind of meaningful future projections or budgets.

Facilities & Location

What is the length of the lease? Is it likely to increase? Are the facilities sufficient for the business and possible expansion? What about the company's location? Are any major roadways or changes in the area likely to affect the company?

Diversity of Accounts

If the company loses one or two accounts will they be out of business? Many companies have one account that equals a large portion of their business. Unless these large accounts are under contract for several years, a buyer may be hard to find. Will the accounts stay with a new owner is the heart of the analysis for the appraiser.

Competition

How strong is competition? What is the level of ease of entry into this industry? Are technological changes going to give a major competitor with more cash a significant advantage?

Predictability

What has the historical financial picture shown? What would it tell a buyer as to what he or she can expect in the future?

Marketability

How hard would it be to sell this company? How many buyers would be interested in this type of business? Does the company have a really unique niche? What is the future of its customer base? Do they manufacture sewing machines or medical equipment?

Future Outlook

Always remember that a business is bought on the assumption of its economic benefit to its owner. The more stable the financial future, as well as other factors like technological changes, environmental regulations, and public attitude, can have an effect on a buyer's emotion. This relates to how long the buyer is willing to risk his or her money and therefore how fast he or she would want it back and thus the multiple of earnings he or she is willing to pay.

In business appraisal, value has its basis in "anticipated future benefits" (earnings). What the company will do in the future is what its value is based on. The risk factors mentioned in this article are the key to the projections that have to be made in the appraisal process and are all critical points that the appraiser must consider.