What is Actually Being Appraised?

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This is a very important question! When I receive a request to appraise a business, one of the first things I attempt to find out, is what aspect of that business exactly, am I being asked to appraise?

There are several different business valuation assignments that I could be asked to complete for any specific business, and each will arrive at a different answer, so you can see why I would need to figure this part out rather quickly.

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I could be asked to appraise a controlling equity ownership in the company stock, member units, depending on how the entity is organized. I could be asked to appraise a non-controlling equity ownership interest, or I could be asked to appraise what many business brokers refer to as the "Most Probable Selling Price" (MPSP). I tend to refer to these projects as an appraisal of the "Assets That Typically Transfer in a Sale".

Each one of those options includes different underlying assumptions, assuming each is governed by the standard of value of Fair Market Value. (If another standard of value needs to be used, then many of the following assumptions are modified again.)

If I am appraising a controlling equity interest, I am going to be looking for discretionary expenses to add back, I am going to be looking for non-operating assets and/or liabilities to adjust out, and I am going to be working this appraisal from the perspective of a potential buyer buying into the scenario as presented with all the assets and liabilities held by the business being considered.

If I am appraising a non-controlling equity ownership interest, I am not necessarily going to be adjusting out discretionary expenses, I may still be looking for non-operating assets and liabilities, but as a non-controlling equity interest holder cannot decide to sell of those assets, I am also not going to be adjusting them out. I am working this appraisal scenario from the perspective of an investor considering the risk of buying into a partnership where distributions to non-controlling shareholders are reduced by the need to fund non-operating assets. I will also be including discounts for lack of control and marketability, IF I am using the fair market value standard of value.

If I am appraising only those assets that typically transfer in a sale, or MPSP, certain adjustments need to be made to many of the methods used. (However, sometimes a buyer will request to purchase some working capital, and that request could throw another wrinkle into the appraisal. Most of the time, that adjustment can be handled by adding a dollar for dollar increase to the appraised value for the requested working capital. Most of the time.)

Let's look at some of the modifications an appraiser must make to application of commonly used valuation methods in order to deliver an analysis of the MPSP.

Any use of the adjusted book value method considering the tangible assets held by the business will need to have cash, and accounts receivable excluded, and the liabilities removed as a buyer in this scenario will not be taking possession of any of those.

Depending on what income stream is selected to run the capitalization of earnings or the discounted cash flow methods, the analyst will have to select a risk rate that matches it, but the most commonly taught income stream is net cash flow, and the most commonly selected rate comes from the build-up method, which means that the indication of value will include an operating level of cash, accounts receivable and the associated amounts of working liabilities. Depending on if the analysis used net cash flow to equity or net cash flow to invested capital, the indication of value may or may not include the effects of the long-term liabilities held. In order to adjust the indication of value to get a MPSP, an operating level of cash must be removed, (If the business holds excess cash, watch out for double counting by removing the excess again at this step.) accounts receivable need to be removed and again, depending on what version of net cash flow was used, liabilities need to be dealt with.

The excess earnings method can derive an equity value or an MPSP value, depending on how the selected income stream was calculated, and if equity or assets were used to calculate the return on tangible assets rate.

Methods under the market approach, if using data from the databases of privately held businesses, typically arrive at an indication of value of the Most Probable Selling Price (MPSP) for an asset sale right out of the gate, but depending on the database used, the analysis may or may not include transactions that were sold as stock deals. When a business appraiser reports a transaction as being sold as a stock deal, it is generally unknown if that transaction included a level of working capital, or if the transaction was structured that way solely for tax purposes, and the buyer did not actually acquire any AR or assume any debt making it more of a modified stock deal. Typically, the transactions reported as asset sales were structured as MPSP deals, but watch out for those transactions where the broker also sold the associated real estate, which would skew the analyzed multiples upwards based on the value of the real property included in that sales price.

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I recently had a request to appraise her business from a potential client. As I went through my normal questions to see what purpose she needed the appraisal for, and to make sure I knew which of the various scenarios described above was needed, she asked me a very interesting question. "Why did I need to know all this information?"

Apparently, she had just been on several websites and received several "valuations" for her business already, and she did not realize that those numbers she had received, were likely for a MPSP scenario, but she was considering selling to an Employee Stock Ownership Plan (ESOP). Quick question to all of the business brokers and advisors reading this:

When you provide your analysis to determine a likely selling price for a business, how confident are you that your same analysis could also be used to fund an ESOP sale?

Most likely, not very confident, as an ESOP valuation requires an entirely different set of assumptions, even beyond what we include when appraising an equity interest.

That first phone call is key, and finding out what we are being asked to appraise and why is also extremely important. Not only for our peace of mind, but also to determine what we are going to charge for the project. An analysis for a MPSP, is likely a lot cheaper than running a report for review by the US Department of Labor.