CFO ADVISORY SERVICES
Creating Value Through Business Strategies

Business Valuation Theory and Early Stage Companies

By Glenn P. Cato

If you are asking yourself, why should any early stage company entrepreneur be concerned about business valuation theory given their most immediate pressures are meeting payroll, getting a product to market or achieving revenue traction? Here are some good reasons to understand the fundamentals.

Before talking about reasons favoring the importance of understanding business valuations, thee frequently asked questions. How important is an independent business valuation when raising a private round of equity? If the round of equity being raised is a Seed Stage or Series A round, there is little if any value to obtaining an outside valuation. Most accredited investors make their own assessment of the risk and return, and the valuation becomes a negotiated amount. These investors know the return on investment they want in order to justify the risk of their investment. Most companies at the Seed Stage or Series A round have very little leverage to negotiate a higher valuation. Companies should expect the "Golden Rule of Business" to apply. "He who has the gold makes the rule." While an independent study of an early stage company is of suspect value, understanding the principals of valuation is important. The most compelling reason is benchmarking a company's performance against the industry segment's premier companies. Identifying the drivers of value within the industry segment provides an entrepreneur with the standards used to compare their company against the best in the industry. These benchmarks are much easier to establish at the outset versus making changes to an entrenched cost structure or operating strategy. Identifying specific benchmarking targets helps entrepreneurs focus on a specific course of action and helps them understand how to measure developmental progress.

To illustrate, let's assume an entrepreneur is developing the next generation software company and decides to resell computer hardware, as a convenience, to customers. Reselling computer hardware typically results in lower margins and when blended with the higher margin software, the overall impact on gross margins will be lower than companies selling only software. In this circumstance, an entrepreneur might decide on a strategy to provide customer convenience, without negatively impacting gross margins. Making this decision will show more consistent gross margin over time, comparable to similar companies in its industry.

Understanding valuation fundamentals can turn qualitative operational strategies into quantifiable increases in value. For example, an entrepreneur's ability to understand that a 10% increase in manufacturing efficiency translates into a several million dollar increase in enterprise value can properly prioritize a particular strategy against other value creating strategies. An entrepreneur focused on value building strategies will maximize cash flow and maximize value creation.

In business there are four standards of value:

- Fair Market Value. FMV is the most common standard of value. The IRS in Revenue Ruling 59-60 defines FMV "as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

- Fair Value. The definition of Fair Value focuses on equitable or equivalent value of the property in question. The definition of Fair Value differs from state to state and is mainly derived from court cases, and therefore is continuously evolving. In these situations it is hard to find a willing seller, thus a fundamental difference between fair value and fair market value. The Financial Accounting Standards Board in FAS 157 *Fair Value Measurements (ASC 820)* states this definition as it relates to financial reporting, "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Such transactions should be an orderly transaction between market participants at the measurement date."

- Investment Value. The definition of Investment Value is the value to a particular investor, rather than a buyer as defined in FMV. The investment value is that value required to meet an individual's requirements or expectations. An example of Investment Value is the valuation at which an investor is willing to invest in an early stage company which fits the Investment Value standard. Most early stage entrepreneurs are under some type of compulsion to complete a deal and fund their future operations and therefore do not meet the definition of Fair Market Value.

- Intrinsic Value. Shannon Pratt in *Valuing a Business* states, "Intrinsic value (sometimes called fundamental value) differs from investment value in that it represents an analytical judgment of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor, but rather tempered by how these perceived characteristics are interpreted by one analyst versus another." For example, if an analyst believes that after an analysis, the business fundamentals for a particular company warrant a price higher than the stock is currently trading, the analyst will conclude there is intrinsic value in the stock that the market has not recognized.

Gary Trugman, author of the AICPA's *Understanding Business Valuations* identifies how the purpose of a valuation drives the applicable standard of value.

Valuation Purpose	**Applicable Standard of Value**
• Estate and gift taxes	• Fair Market Value
• Inheritance taxes	• Fair Market Value
• Ad valorem taxes	• Fair Market Value
• ESOP's	• Fair Market Value
• Financial acquisitions	• Fair Market Value
• Corporate or partnership dissolutions	• Fair Value (most states)
• Going Private	• Fair Value (most states)
• Stockholder disputes	• Fair Value (most states)
• Strategic Acquisitions	• Investment Value
• Buy-Sell Agreements	• Both parties must agree
• Marital Dissolutions (divorce)	• State case law determines

In summary, applying a working knowledge of valuation fundamentals to qualitative operational strategies translates into a quantitative impact on enterprise value. The ability to prioritize a large number of operational initiatives ensures a company is generating optimal cash flow and is well positioned to achieve a successful liquidity event.

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CFO Advisory Services also provides value creation strategies assisting clients in developing their growth or exit strategies. Glenn has worked with clients in a variety of industries to achieve the goals of owners / entrepreneurs. If we can be of service, please contact Glenn at gcato@cfo-advisory.com.