Chapter 14 Business Valuation and Harvesting

Entrepreneurial Finance: Fundamentals of Financial Planning and Management for Small Business, First Edition. M. J. Alhabeeb.

14.1 What is Business Valuation?

Business valuation is one of the essential tasks to undertake for many reasons. It would be necessary to know a current and reliable value for the firm in cases of financing, selling, or merging the company, as well as in cases of selling stock to employees, harvesting, and even when making charities. Firm valuation is also required by both federal and state authorities, not only for tax purposes but also for a myriad of reasons such as the cases of inheritance, property transfer, antitrust problems, partnership disputes, divorce, liability suits, and going public.

The usual element in the context of value would be the dynamic relationship between the overall return and the risk involved. This relationship is very much related to numerous dimensions such as the business performance, its sales, revenue, profits and the rate of their growth, assets, liabilities, cash flow, capital, and the external environment of market, suppliers, competitive forces, threats, and customer base.

Business value is usually influenced by many business-related factors such as:

- type of business and industry;
- size and performance;
- history, current, and projected state;
- development stage and growth rate;
- management and control;
- business statistics (assets, liabilities, revenues, profits,..., etc.);
- reason of valuation.

Valuation of a business would eventually come down to assessing the ability of the business to generate cash flow from the point of sale and on into the future. Along with assessing this ability, it is essential also to assess the risk levels under which the estimated cash flow

would continue to be flowing, and also consider the expenses that would be incurred to maintain and increase that cash flow. Value of a business in the eyes of a prospective buyer would, in layman's terms, mean that “any dollar spent on the business should continue to yield more than a dollar throughout

the future of the business, and any sure dollar is more preferred than any speculative dollar." That would basically sum up a good lesson on the expected cash flow and business risk.

While Chapter 3 went briefly over the major considerations to determine the appropriate value of a business under a purchase decision, here we go into more details of the process of firm valuation, and how it is especially related to business harvesting.

14.2 Valuation Tools

Business value can be obtained in many ways and from different points of view. There are several valuation tools we can summarize here:

Book Value of Assets and Shares

Book value, which is the value of assets and shares that is documented in the firm's records, has been one of the old and common tools for valuation. It is also the most criticized for its inaccuracy and lack of connection to the actual market value. A major criticism comes from the Internal Revenue Service (IRS), which states that book value may have a historical but not practical significance unless all assets are appraised at the current market prices, and the intangible assets are included. Book value is still used in valuation for certain purposes such as liquidation.

Market Price of Shares

Market prices of the firm's stock and of comparable firms' stocks can also serve as a tool to determine the firm's value as long as they are current prices and free of any market restrictions including any restriction on the freedom of information to all investors. Using a proxy for market prices based on the prices of similar companies can only be plausible theoretically, but practically it is very difficult to find companies that are similar.

Capitalization of Major Variables

Capitalization in finance usually refers to obtaining the present value of a stream of future cash flow. As tools for valuation, many major business variables and indicators can be capitalized for a future period of time, such as 5 years, as it is commonly used. Income, earnings, cash flow, dividends, sales, and revenues can all be capitalized, and can serve as indicators for the firm's value. The relevance of the calculated value would depend on the

way those variables are projected and also on the capitalization rate, which would be used to discount the value of the future stream into the present value. The capitalization rate would implicitly count for the risk characteristics of the firm as it stands for the extent of certainty to receive the expected future income. The use of capitalization of income and earnings is approved by the IRS and other

financial authorities. There are two capitalization rates: the overall rate and the equity rate. The overall capitalization rate is usually used for discounting the future income before interest but after taxes. The equity capitalization rate is used to discount the firm's future net worth.

As to estimate the future income or earnings stream, several methods can be employed. For a linear growth, the simple econometrics method of least squares regression would be appropriate, and beyond that there would be other methods such as the exponential curve fitting, and geometric progressions. Also, the weighted average can be used where the heavier weights are given to the most recent data, and the least weights are given to the older data. Some seasoned companies would only depend on applying an estimated growth rate to the current data of earnings or income.

Since some firms try to reduce taxes by adjusting reported earnings, a stream of future cash flows could be a better alternative to ascertain the firm's value. Firms producing services can be better off using a certain multiple of sales or revenue or other variables after devising a suitable multiplier.

14.3 Valuation Techniques

Different firms use different methods of valuation for different purposes at different times. There is no secret that any valuation method may contain a certain level of subjectivity and bias for its own purpose. Generally speaking, a seller would like to increase the value and a buyer would like to decrease it, tax collectors would like to maximize the value in order to maximize the taxes due, and insurance companies would like to minimize the value for the purpose of minimizing the compensation. Common sense indicates that a safe way might be to go with what is common in the industry and to use more than one method to make sure that the result is not far off from what is reasonable. The common techniques to obtain a firm's value can be grouped under two major approaches, the approach that considers value as a plain multiple of a selected major variable, and the approach that discounts a future stream of selected variables into their present values. That latter approach is what we called earlier the capitalization of major variables.

The Multiplier Approach

In this approach, a major variable such as the firm's cash flow is multiplied by a factor (multiplier) to reach an approximate value of the firm. Cash flow here would refer to the firm's ability to pay for the company's debt obligations and equity payments such as

dividends. What is commonly used is the firm's earnings before interest, taxes, depreciation, and amortization (**EBITDA**). The multiplier is determined by several factors related to the company's strength and growth, its status in the industry, market conditions, and the like. It is usually a number between 3 and 10, but it could very well be exceeding 10, although the conventional wisdom has been to tell the buyer not to pay for a business which has been valued using more than 5 as a multiplier.

However, there have been some cases when buyers accepted to buy businesses they knew were valued using a multiplier as high as 20.

It is noteworthy to mention here that the fact that the entrepreneur pays for himself in the transaction, as a seller, can sometimes be used to manipulate the estimated value of the firm. The entrepreneur would usually like to include his payment within the EBITDA to inflate the estimation, while the business buyer would like to exclude it to underestimate the value. A compromise could be reached when both parties are partially satisfied so that the net amount would be considered.

Example

Suppose that a local business is for sale where its estimated EBITDA is $800,000 and its entrepreneur's salary is $150,000. What would its value be if the multiplier is 6.5 and the prospective buyer intends to pay himself $130,000?

$$V = m[\text{EBITDA} + P_s - P_b]$$

where

V: estimated value of a business
m: multiplier
P_s: payment to seller
P_b: payment to buyer
$V = 6.5[800000 + 150000 - 130000]$
$V = 5330000$

In some industries, EBITDA can be replaced by what is called **Free Cash Flow (FCF)**, which is the EBITDA after subtracting capital expenditures. Manufacturing firms usually use a multiple of FCF in establishing their values.

Sales revenue is a big determinant of value for some firms such as those in the technology, internet, media, and food services. The multiplier used for the sale revenue ranges between 3 and 5 on average. As for online businesses, a new criteria has been emerging in the last few decades. It is the number of internet visitors and online hits on the site. According to Rogers (2009) **myspace.com** was purchased for $580 million by News Corporation in 2005, when the value was determined based on 197,952,218 visitors per month. This made the value equals to $2.93 per visitor a month. When Google purchased YouTube in 2006, it had

to pay $4.00 per monthly visitor of YouTube, which had shown 412,500,000 million visitors per month. Google's bill of purchase was $1.65 billion. Two years later, in 2008, the purchase price of the internet visitor has risen to $9.40 per visitor a month when the weather channel was purchased by NBC for $3.5 billion.

Price–earnings ratio (P/E) has been used as the multiplier in the valuation of the firms that have publically traded stock. It is to be multiplied by the firm's after-tax earnings to estimate that firm's value. Let us recall that the P/E is calculated by dividing the market price of common stock by the firm's earnings per share (EPS), which itself is obtained by dividing the firm's net earnings (after preferred stock dividends) by the number of shares. This is to say that the value of the P/E

is depending on the stock market price, the firm's earnings, and the number of outstanding shares. Those three variables are themselves influenced by other factors. For example, investors in the market would be willing to pay a higher price for a stock most likely because they value some of the known firm's characteristics such as high and consistent growth rate, innovative management, number of new patents, none or low number of legal troubles or lawsuits, desirable and reliable products, and so on. We can easily conclude that the higher the P/E, the higher the value of the firm. Some privately held companies may use their P/E as a multiplier although such a practice is not common. However, if the P/E is used to obtain the value of a private company, it should be estimated based on the P/E of a closely comparable public company. Comparable closeness would mean they are similar in many respects such as size, sales revenue, profitability, growth rate, and experience. Different firms use different multipliers and benchmarks depending on many factors related to both internal and external status. Also, the multipliers and benchmarks used in valuation change from time to time, even within the same industry, and for the same firm. Table 14.1 shows the general rule-of-thumb used in valuation for different industries.

Table 14.1 General Standards for Valuation in Different Industries

Industry	"Rule of Thumb" Valuation
Accounting firms	100–125% of annual revenues
Auto dealers (new cars)	0–10% of annual sales + inventory
Book stores	15% of annual sales + inventory
Coffee shops (gourmet)	40% of annual sales + inventory
Day care centers	45–50% of annual sales including inventory
Dental practices	60–65% of annual revenues including inventory
Dry cleaners	70–80% of annual sales + inventory
Engineering services	40–45% of annual revenues
Flower shops	30–35% of annual sales + inventory
Food shops (gourmet)	30% of annual sales + inventory
Gas stations (w/o C-store	15–20% of annual sales + inventory
Gift/card shops	35% of annual sales including inventory
Grocery store (supermarket)	15% of annuals sales + inventory
Hardware stores	45% of annual sales including inventory
Insurance agencies	125–150% of annual revenues
Landscape businesses	45% of annual sales
Law practices	90–100% of annual revenues
Liquor stores	40–45% of annual sales + inventory
Restaurants (full service)	30–35% of annual sales + inventory
Restaurants (Limited serve)	30–40% of annual sales + inventory
Sporting goods stores	25% of annual sales + inventory
Taverns/bars	40% of annual sales + inventory
Travel agencies	35–40% of annual commissions
Veterinary practices	70% of annual revenues + inventory

Source: http://bizstats.com/reports/valuation-rule-thumb.php (2013).

The Capitalization Approach

As it was mentioned earlier, major variables such as the firm's cash flow, earnings, sale revenue, and gross margin can be projected for a certain future period and discounted into their present value using a firm capitalization rate to estimate the firm's value. As an example for this approach, and to apply this technique to the firm's free cash flow (FCF), we can use the following formula to obtain a firm's value (*V*):

$$V = \mathrm{PV}(\mathrm{FCF}_t) + \mathrm{PV}(\mathrm{RES})$$

$$V = \sum_{t=1}^{n} \left[\frac{\mathrm{FCF}_t}{(1+\mathrm{cr})^t}\right] + \left[\frac{\mathrm{FCF}_{n+1}}{(\mathrm{cr}-\mathrm{gr})(1+\mathrm{cr})^n}\right]$$

where:

V: the firm value
FCF: the firm projected free cash flow for any year (*t*) of the projection period (*n*)
cr: the firm capitalization rate
FCF_{n+1}: the projected free cash flow for the year immediately following the selected projection period (*n*)
gr: the firm's expected growth rate

The formula indicates that the firm's value is estimated by adding up two sub values (the right-hand side of the formula). The first sub-value is the present value of the firm's free cash flow during the projection period (*n*) or as it is sometimes called the "**planning period**," or the "**explicit period**." The common length of projection is 5 years ($n = 5$) where *t* is the general symbol of any of these years. The detailed capitalization formula would be

$$\mathrm{PV}(\mathrm{FCF}_n) = \left[\frac{\mathrm{FCF}_1}{(1+\mathrm{cr})^1}\right] + \left[\frac{\mathrm{FCF}_2}{(1+\mathrm{cr})^2}\right] + \left[\frac{\mathrm{FCF}_3}{(1+\mathrm{cr})^3}\right] + \left[\frac{\mathrm{FCF}_4}{(1+\mathrm{cr})^4}\right] + \left[\frac{\mathrm{FCF}_5}{(1+\mathrm{cr})^5}\right]$$

where FCF_1 to FCF_5 are the forecasted values of the firm's free cash flow for the next 5 years. Every forecasted value of the free cash flow would be equal to the earnings before interest and taxes (EBIT) after adjusting it to depreciation, taxes, capital expenditures, and any increase in the operating working capital:

$$\mathrm{FCF} = \mathrm{EBIT} + \mathrm{depreciation} - [\mathrm{tax\ rate} + \mathrm{capital\ exps} + \mathrm{increase\ in\ operating\ working\ capital}]$$

The second sub-value is the present **value of the residual** (RES). This is the period beyond the explicit period (5 years here) and into the future. Since the present value declines to an insignificant amount as we go far into the future of cash flow, the residual or the **implicit period** is usually summed up in one discounted value. This

value would be, in one treatment, based on the free cash flow of the year immediately following the projection period. Since the projection period is 5 years, FCF_{n+1} would be $FCF_{5+1} = FCF_6$.

Example

The following data is for a company that is to be valued using the capitalized free cash flow technique.

- Projected EBIT for the 5-year period (2014–2018): 210,000; 245,000; 270,000; 298,000;338,000;
- Tax rate: 39%;
- Depreciation: 21%;
- Projected FCF for the year 2019 is 280,530;
- Increases in operating working capital: 1,200, 3,125, 3,757, 3,972, 4,750, respectively;
- Capital expenditures: 335,410, 473, 528, 639, respectively.

Calculate the firm's value if the capitalization rate is 15% and the firm is expecting a growth rate of 11%.

First we have to adjust the EBIT values into free cash flow values. We can arrange that in Table 14.2.

Obtaining the projected values of FCF for 2013–2018, we can now calculate their present value:

$$PV(FCF_5) = \left[\frac{FCF_{2014}}{(1+cr)^1} + \frac{FCF_{2015}}{(1+cr)^2} + \frac{FCF_{2016}}{(1+cr)^3} + \frac{FCF_{2017}}{(1+cr)^4} + \frac{FCF_{2018}}{(1+cr)^5}\right]$$

$$= \left[\frac{170645}{(1+.15)^1} + \frac{197365}{(1+.15)^2} + \frac{217170}{(1+.15)^3} + \frac{240270}{(1+.15)^4} + \frac{271771}{(1+.15)^5}\right]$$

$$= 148387 + 149236 + 142793 + 137375 + 135118$$

$$= 712909$$

Table 14.2

Year	EBIT	+ Depreciation 21%	− Taxes 39%	− Capital Expenses	− ↑Working Capital	FCF
2014	$210,000	44,100	81,900	355	1200	170,645
2015	245,000	51,450	95,550	410	3125	197,365
2016	270,000	56,700	105,300	473	3757	217,170
2017	298,500	62,685	116,415	528	3972	240,270
2018	338,000	70,980	131,820	639	4750	271,771

Now, we can find the present value of the residual.

$$\begin{aligned} \text{PV(RES)} &= \frac{\text{FCF}_{n+1}}{(\text{cr} - \text{gr})(1 + \text{cr})^n} \\ &= \frac{\text{FCF}_{2019}}{(.15 - .11)(1 + .15)^5} \\ &= \frac{280530}{(.04)(2.01)} \\ &= 3489179 \\ \text{V} &= \text{PV}(\text{FCF}_n) + \text{PV(RES)} \\ &= 712{,}909 + 3{,}489{,}179 \\ &= 4{,}202{,}099 \end{aligned}$$

Since the capitalization approach depends on the present value of predicted stream of cash flow in a future time, it is plausible to assume a certain level of risk accompanying the realization of that cash flow during the specified time frame. Valuation methods have counted for such a risk in two ways: either to adjust the capitalization rate or to adjust the cash flow. Recall that these very same methods were explained earlier. They were: the risk-adjusted discount rate (RADR) and the certainty equivalent cash flow (CE_q).

In the RADR method, the capitalization or discount rate was adjusted to reflect a certain level of riskiness in obtaining the future stream of cash flow. The adjustment would generally be adding what is called a risk premium to the selected cost of capital for the firm:

$$\text{cr}_{\text{adj}} = \text{cr}_{\text{f}} + \text{rp}$$

where cr_{adj} is the risk-adjusted capitalization rate, cr_{f} is the standard capitalization rate, which is supposed to be risk free, and rp is a risk premium to count for a selected risk level. Although such adjustments may sound easy in a theoretical sense, it is actually not easy at all in practice. The difficulty comes from deciding that risk premium and identifying the factors that would determine its value.

On the other hand, instead of adjusting the discount rate, the certainty equivalent cash flow method would adjust the values of cash flow before discounting them into their present value at the usual cost of capital-based discount rate. In this adjustment, a selected amount that would compensate for the potential risk would be subtracted from each value of the forecasted cash flow. For example, if we want to adjust the free cash flow that we had in the previous example, it would be this way:

$$FCF^{t}_{adj} = FCF_{t} - rd$$

where FCF^{t}_{adj} is the risk-adjusted free cash flow for year t, FCF_{t} is the unadjusted free cash flow for the same year (t), and rd is the risk discount amount. Practically, firms that follow this method often find it easier than the RADR perhaps because they can estimate the risk discount better than they estimate the percentage risk premium.

Varieties of the Capitalization Approach

There are several varieties in the application of the capitalization approach to calculate a firm's value. Here we briefly describe two common methods.

The Traditional Venture Capital Method

We can summarize the major features of this method as follows.

- It uses the firm's net income to get the explicit value in the projection period. The data are chosen from what is called the “success scenario,” which would refer to the best state of the firm's performance.
- It obtains the continuing or residual value in the implicit period by applying a P/E to the projected earnings. The P/E is carefully selected from a publically traded firm that is closely comparable.
- It uses a very high discount rate in discounting the value into the present time. The high rate is supposed to compensate for any possibility of having an inflated forecast that is based on data representing the best state of the firm.

The First Chicago Method

This method was developed and renamed after First Chicago Corporation of Venture Capital. Its major features can be summarized as:

- It uses the firm's cash flows during the projection (explicit) period using three selected scenarios representing three performance states for the firm: best, moderate, and worse states. They are also called success, neutral or sideways, and failure states.
- It obtains the continuing or residual value in the implicit period by applying a proper multiplier to the financial projection for the three aforementioned states.
- It calculates the expected cash flows for the firm by taking the probability-weighted sum of the three scenarios, where each scenario value is multiplied by the assigned scenario probability.
- It obtains the present value for the two periods cash flows using a discount rate equal to the opportunity cost of capital. This discount rate is usually lower than the one used by the traditional method.

Harvesting

14.4 What is Business Harvesting?

Just like agricultural harvesting, when farmers know what to do with their crops that they usually obtain after a long and exhaustive process of cultivating, planting, and growing, entrepreneurs and equity investors must know when and what to do with their business after it matures and acquires a defined status. **Harvesting** is an anticipated and planned exit strategy by which an entrepreneur or investor would extract the best value possible out of their committed investment. Harvesting is also

used in business as to refer to the state of reducing or eliminating a type of business or line of product when it is determined that further investment would not be profitable anymore. This could happen when a line of product becomes obsolete or just falls out of favor, such as the case of the traditional landline phone, the demand on which faded away remarkably at the explosion of the popularity of the cell phone. The producing firms would be better off to stop investing in the traditional phone project and consider it as a “cash cow” and try to extract the best out of it. In this case, the firm can divert all funds and energy to the most marketable line of cell phones, and in this sense, harvesting takes the meaning of planned discontinuation of a business or product at the end of their perceived life span. For a new venture, entrepreneurs and venture capitalists would look at harvesting as the last stage of their project in which they get the expected value out of their investment so that they could move on to another project.

14.5 Harvesting Strategies

The common strategies to harvest a business would fall into four general categories:

- systematic liquidation;
- outright sale;
- acquisition; and
- going public.

Generally speaking, harvesting is not an easy process but it can be successful if it is done at the right time with a proper plan, and sensible execution of the plan. As far as timing is concerned, most new ventures would be harvested in a frame of time between 3 and 10 years after inception. If the entrepreneur expects a smooth and reasonable outcome, harvesting would need to be professionally handled, and the value of business has to be fairly and objectively estimated.

Systematic Liquidation

This harvesting strategy is particularly good for the closely held business. It is also called the asset distribution to owners method. The process involves the gradual liquidation of business assets and the systematic distribution of their value among the owners. It would require the accumulation of cash flow after the investment in assets has been slowed down and probably ceased in preparation for harvesting. The accumulated positive value would be distributed in the form of dividends or repurchase of equity. The cash outflow to owners

would continue while the cash inflow to growth is stalled until all the business value is exhausted and the operations are ceased. This strategy may be ideal for a business in decline or a line of product that is out of fashion. The gradual decrease of growth funds and gradual liquidation would go hand in hand with the decrease in demand on the product and in revenue. This specific approach to harvesting offers a smooth and quiet exit that is not costly and does not require a lot of fanfare.

Outright Sale

This strategy is performed specifically for the entrepreneurs and investors who seek upfront cash and relative speed of execution. It is basically the strategy of selling the business to others such as family members, management team, the business employees, or to any outsider. Transferring a business to family members such as children or siblings is a common practice, especially among the businesses that have been originally established as family businesses. The ownership transfer can be done either by giving the business or part of it as a gift or by selling it, or by both ways, gifting and selling. The most contentious issue here can be the transfer tax. The federal gift tax law allows certain limits of the business's fair value to be exempted from taxes, while the rest of the value would be taxed at a normal rate. However, if the owner attempts to lower the total value of business to reduce the taxes on the transfer to his family, the IRS would impose the rate that it would consider fair. That would be the federal gift tax rate on the difference between the lowered price of the transferred business and its market fair price. This market fair price is defined by the IRS 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, and both parties having reasonable knowledge of relevant facts." (Revenue Ruling 59-60, 159-1, 13237). The other possibility is to sell the business to existing partners or the current management team. It is known as **management buyout (MBO)**. If managers cannot afford to pay for the business, as is the case most often, they would finance the purchase by debt from lenders or by bringing in other investors. In this case, the buyout would be called a **leveraged buyout (LBO).** A management buyout option of harvesting can be advantageous, especially if it is known and arranged from the beginning. It would be less costly since the management team knows everything about the business and does not need to waste funds on the due diligence and other transactions. Also, it would be expected that the managers turned owners would be very efficient and can run the business with the resolve of making it even more successful than before. Needless to say, that a management buyout would not occur in the first place unless the business has proved a certain level of success and the managers know, and are determined to take over and make it even better. Another avenue for harvesting is to sell the business collectively to the current employees in what has been termed as ESOP or **Employee Stock Ownership Plan.** This plan was approved and enacted by Congress through the 2001 enactment of the IRS code section 409P, which required an equitable share of ESOP benefits between investors and employees. It would basically allow an internal market for the company's shares by opening the doors for employees to invest their retirement funds in their company's equity.

The individual investment would be liquidated when an employee retires or leaves the company. ESOP can be either leveraged or unleveraged. As for owner's objective of harvesting, there would be, of course, a trade-off in getting their liquidity. Leveraged ESOP would expedite obtaining liquidity but would add more complications while unleveraged ESOP is straightforward but takes a longer time for owners who seek to wrap up the process of harvesting as soon as possible.

The last type of outright sales is what is known as **divestiture**. It is the partial selling of a firm's assets or some of its operating units, plants, divisions, or even an entire subsidy. The common purposes of divestiture are:

- streamlining the operation;
- eliminating a declining line of product;
- getting rid of poor performance; and
- restructuring the business.

Whatever the reason is for the partial sale of assets, divestiture can be thought of as a preliminary step for harvesting a business.

Acquisition

Entrepreneurs and owners of a business may prefer yet another way of harvesting through getting their business to be combined or acquired by another firm. **Acquisition** is the act and process of taking over all or part of an existing business by another business, often a strong competitor. It usually involves the possession of assets, purchase of equity, custody of records, and control over the voting rights. While the major purpose for the acquired business, in our discussion here, is the harvesting of value, the only purpose of the acquiring company is more growth and higher control over the market. The most common forms of acquisition are as follows.

Consolidation

Consolidation refers to combining two or more comparable companies, especially in size, into one that is new and different from the original companies, which would cease to exist, thereafter. The equity and assets of the forming companies would be melting into the assets and equity of the newly formed firm.

Merger

When two or more companies need to be combined and they are different in their size and stature, a **merger** would occur. In this case, the identity and characteristics of the acquired company would be fading away within the largest and most powerful, the acquiring company. Both equity and assets of the smaller or follower company would be consolidated into the larger and leader company that would pay for them either in cash or in preferred

or common stock of the leader company. Needless to say, the harvesting entrepreneurs and managers would prefer the cash payment for the instant liquidity they seek.

Holding Companies

A holding company is a company that is able to purchase at least 20% of the outstanding stock of other companies. This type of ownership share would grant the holding company a significant voting control of the subsidiaries or the controlled companies.

In any form of acquisition, a harvested business can sell either equity or assets or both. It can also sell for either cash or stock of the acquiring company. In selling equity, the acquiring company would take all assets and assume all liabilities. In selling the assets, the acquiring company would not be responsible for the liabilities, and for such an advantage, the selling price would be higher than the price of selling equity. In other words, it is a risk reduction for the acquiring company to take the assets

and leave the liabilities. Selling the business equity for cash would be considered the best scenario of harvesting for the venture investors but may not be that perfect for the venture entrepreneurs, especially if they are emotionally attached to their projects in addition to the tax burden that they would bear.

Closely held companies seeking to harvest their businesses can also accept stocks for their assets and equity as an alternative to accepting cash. Since the liabilities remain the responsibility of the harvesting business in case of selling assets for stock of the acquiring company, the preference becomes selling equity for stocks. That, of course, implies its advantages and disadvantages to both parties. Among the significant concerns is the value uncertainty of the stocks of both companies being exchanged. This would require some due diligence on both sides to make sure what they are getting into. Needless to say, if either or both companies have publically traded stocks, it would make it much easier to settle with the stock value. Among the possible advantages for the harvesting company when it exchanges stock for stock is the longer window of time that would allow it to defer taxes as compared to getting cash for the transaction.

Going Public

Going public means that a closely held company becomes a publically traded business by selling its equity shares to the general public. While it is a common practice for some businesses to go public in order to raise capital by sharing new shares to investors in the public market, it is also a way for entrepreneurs and investors to harvest their business by making their business shares freely tradable in the investor's public market. The first sale of the newly offered shares to the public at large, called **Initial Public Offering (IPO)**, would help establish market for those shares and allow their value to be determined freely.

Companies that plan to go public have to first contact an investment bank and see if the bank would agree to underwrite the company's shares, which means studying, evaluating, and agreeing to own them and be legally responsible for them. For investment banks to underwrite an IPO, they usually have their own requirements for the company to be going public. They want to make sure that when the shares are offered in the open market, they should have a value that is worth the bank's responsibility and efforts. Among the qualifications that the company has to show are:

- having a desirable and innovative product;
- being a competitive partner in its own industry;
- exhibiting a high growth prospect;

- proving successful in meeting the standard financial audit requirements;
- making certain levels of revenue and profits.

The process of going public and having an IPO can be summarized by the following steps.

- Survey potential investment banks and select one to be the underwriting entity.
- Make sure that the bank requirements are met.

- Contract with the bank as the official underwriter.
- Participate in the bank decisions to evaluate the company's equity shares, price them, and determine when and where to trade them.
- File the IPO registration with the Securities and Exchange Commission (SEC) and follow and obtain its approval.
- Start marketing the IPO to potential investors that are specifically identified by the underwriter bank. This step is called the "**road show**."
- Obtain and accumulate tentative commitments from investors as a minimum before the actual IPO takes place.
- Determine the final price of the stock and the number of shares to be sold as close as possible to the selected day the IPO would occur.

Reasons For and Against Going Public

There are many reasons why a company goes public but most of the practically documented reasons are more conducive to the objective of raising capital than to the objective of harvesting. Among the general reasons are:

- offering a relatively less expensive source of capital as compared to debt capital.
- bringing about a level prestige and strengthening the stature of the shares in the market. This would be particularly helpful for future market trading and not so helpful for a company that wants to wrap up and harvest.
- facilitating acquisition, as the company and its value becomes more exposed to other investors and companies seeking to acquire and expand.
- diversifying ownership.

As for the reasons against going public, they can be generally summarized as:

- long and costly process. The preparation and execution of going public is estimated to take 2 years on average. The cost can be astronomical including a variety of expenses such as legal fees, accounting fees, underwriting fees, printing costs, registration fees, indemnity insurance, and the like.
- high level of disclosure and loss of privacy for the owners personally, and for their business's privacy of policies and practices.
- increased liability for managers and officers.
- additional difficulty in the decision-making process.
- added tendency to favor short-term goals and forgo the long-term projects.
- dealing with elaborate and restrictive SEC regulations.

As specifically for harvesting, the IPO may be considered as the beginning of the harvesting process. Generally speaking, there would be some reluctance by the investors of the closely held companies to sell during the IPO, as opposed to a more flexible and relaxed position after the IPO. There would commonly be a lock-up period after which existing shareholders can be free to go on a direct sale in the free market to achieve their harvesting objective.

14.6 Summary

This chapter was on business valuation and harvesting. The meaning and the needs for valuation were addressed first, and the valuation tools were listed and explained. The valuation techniques were presented next. They included the multiplier approach and the capitalization approach. Each was explained with numerical examples. The next topic was how to account for valuation risk, followed by a variety of capitalization approaches such as the traditional venture capital method, and the first Chicago method. The rest of the chapter was dedicated to business harvesting. This section of the chapter went over what is harvesting, how important, and for what purpose the business would be harvested. Also, the harvesting strategies were listed and explained. They included systematic liquidation, outright sale, acquisition, and going public. The acquisition was detailed into three categories: consolidation, merger, and holding companies. Finally, in addition to explaining the term “going public,” the requirements to do so by any company were listed, and the process was detailed. Also explained were the reasons against this strategy of a private company going public.

Key Concepts

Business valuation Book value Capitalization
Multiplier approach EBITDA Explicit period
Implicit period Planning period Value of residual
Traditional venture capital First Chicago Harvesting
Systematic liquidation Asset distribution to owners
Outright sale Acquisition Going public
Management buyout (MBO) Leveraged buyout (LBO)
Employee stock ownership plan (ESOP) Divestiture
Consolidation Merger Holding companies
Initial public offering (IPO) Road show

Discussion Questions

1. Define business valuation and list its major purposes.
2. What are the major tools for valuation, and how would they be different from each other?

3. There are two basic approaches that can be taken to determine a business valuation. What are they and how would the value be calculated under them?