HOW MUCH IS YOUR BUSINESS REALLY WORTH?

Having a feeling for how much your business is worth (its value) is another, ex-salary, means of measuring your financial growth. If for no other reason than curiosity, most of us would like an idea of what it is.

More important though, there are also specific times when value must be determined. For example: selling to an outside buyer… sharing ownership… merging with another firm… getting a divorce… establishing an employee stock ownership plan (ESOP)… preparing a buy/sell agreement… funding a buy/sell with life insurance… dissolving a firm and distributing its assets.

The more that's at stake, the more important it is to have a realistic valuation—one that's based on clearly supported data that is defensible, even in court.

BUT FIRST, A REALITY CHECK

Unlike other types of companies, creative services firms seldom invest in facilities, have no product inventory, and have relatively few hard assets. Products are also intangible, ephemeral ideas. And income is often directly related to the talent of the principal(s), a situation that can be exacerbated by their involvement in all the firm's activities.

For all these reasons, the value of most creative firms is usually less than firms of comparable size in other industries. Indeed, in many cases, and especially with freelances and shops with fewer than five employees, there is little value aside from the hard assets and the paycheck that the principal takes from the firm each week.

This is mentioned here not only to avoid unrealistic expectations, but also to set the stage for why the process of valuing a creative firm is somewhat different than that used for other companies.

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WHAT TO CONSIDER

Not only do business valuations have to be readily accepted by others, they also must be *accurate*. As examples, if the value of your business is set too high, you could end up paying higher insurance premiums than necessary, or fail to find a qualified buyer; if too low, you could end up being on the short end in an insurance loss or when negotiating a buy/sell agreement. To increase your odds of getting an accurate valuation, keep the following points in mind:

Does the person doing the valuation have relevant experience? A business valuation is essentially a financial audit that also includes a substantial "industry norms" component. Accuracy requires that whomever prepares it have intimate knowledge of both. For example, your accountant may be very well qualified on the numbers side, but lack crucial industry-specific knowledge. Whomever you choose, make sure you get, and call, references.

Does your business have enough history? An accurate valuation requires drawing upon at least three years worth of data. Valuations that are based on less data are usually suspect.

Is the approach formulaic? Be wary of those who provide a valuation by merely plugging numbers into a predetermined formula. In industries with extensive data histories it is sometimes possible to provide a reasonably accurate one this way. But the only way to get an accurate valuation of a creative services firm is through a combination of numbers, research, and industry knowledge. Be sure to ask what information you'll need to provide. (See "What Is Required" on page 3.)

Is it the real thing? Don't take valuations provided by those selling other services—e.g., insurance, or personal financial planning—seriously. Not only do you get what you pay for, but an unrealistic valuation can lead to dangerously false conclusions.

What's the end result? You should get a hard number ($ value), all the supporting financial data, and a thorough explanation. The formulas used should be apparent, too. This permits doing updated valuations later by plugging in new numbers without going through the whole process.

VALUATION BASICS

There are two major elements to a business valuation. Net asset value (NAV), the business' liquidation value, is determined first. Then return on investment (ROI), or the value of a future income stream, is calculated.

Net asset value (NAV). This is the business' equity, how much money would be received if everything was sold off or cashed in. It is determined by adding up cash on hand, accounts receivable, savings, and the market value of items like computers, peripherals, desks, etc. Subtracted from this figure are accounts payable, long-term debt,

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lease obligations, and any other financial commitments.

Net asset value is the foundation of a business valuation because the market value of a company can never be lower than this figure. *It is the only value that many creative firms, including nearly all freelance and small firms, have.*

Return on investment (ROI). This is sometimes referred to as the business' "goodwill." ROI can be determined in several ways, but the only way that usually makes sense for closely-held small businesses is looking at the amount of demonstrable, predictable profit that has been generated in the past several years.

After examining the basis for a firm's profit, the valuator arbitrarily assigns a number (multiple), which is used to determine the ROI component of the valuation. Multiples for small businesses having sales of less than $1 million are typically from 3.0 to 4.0; larger firms a higher number. (The multiple is based on the valuator's experience, and several standard accounting procedures.)

What does this mean? A multiple of 5.0, which assigns a higher value to the business, means that the valuator believes that a potential investor would be comfortable with only a 20% return on investment (ROI). A multiple of 4.0, which assigns a lower value to the business, means that the valuator believes that there is higher risk involved, and that an investor would demand a return of 25%.

HOW THE VALUATION OF A CREATIVE FIRM IS DIFFERENT

Although assigning a multiple is crucial to any valuation, the way it is normally derived does not address many of the specific issues facing a creative services company. This tends to lower the valuation multiple used.

Because of the unique nature of creative services companies, it is usually better to standardize on a single "average" multiple (4.0), then apply some fifteen industry-specific adjustments (factors) to it. (See the Valuation Worksheet on page 5.)

"Hard" ROI adjustments. These are the objective adjustments used to factor the multiple. For example: adding previously expensed items back to the balance sheet… accounting for work in progress… allowing for income tax for current year "profit" in an S-Corp, or corporate taxes with a regular C corp… and properly allocating salaries as cost of goods sold (COGS) or overhead, regardless of W-2 or 1099 status.

> *There's No Market Value For Most Firms Of Fewer Than Five.*

"Soft" ROI adjustments. These are the subjective adjustments used to factor the multiple. They are applied after the formula has yielded an initial valuation number. They take into account such things as the end-purpose of the valuation (selling to an outside buyer, divorce settlement, sharing ownership, etc.), the way the firm is structured, and where the business comes from.

As an example, suppose the valuation is requested to help set the value of ownership shares. The initial valuation figure is $500,000. Although the whole firm may be worth this much, one-quarter of it is not worth $125,000 to a non-controlling stockholder. This is because of his or her inability to control dividends, set salaries, and affect the destiny of the business. In such cases, a "minority discount" factor deducts from the valuation of their share. (A "control premium" factor may also add to the share of controlling stockholders.)

Other examples would be a "risk" factor if a large portion of the business came from a single client, or a "non-attractiveness" factor if the business had a number of difficult clients. Conversely, another factor might increase the value if the business was well diversified, or specialized in a growing and lucrative field.

WHAT RAISES A CREATIVE FIRM'S VALUE

The key to a creative services firm with high market value is *not* talent. Because talent is ephemeral and tied to specific individuals, it creates little in the way of long-term (transferable) value.

Rather, the key is good management. It is having hired exceptional talent and supporting it with the systems, procedures, and marketing that have led to consistent profitability. In turn, this has led to a business whose name and recognition ("brand") can be transferred to others with minimal negative impact.

In fact, the ownership of most creative firms is never transferred. The reason is simply that they haven't been well enough managed to create transferrable value.

Size and stability. Except in unusual situations, creative firms of fewer than five individuals seldom have any value greater than fair market value of their hard assets. If you run a firm of this size or smaller, chances are you will have to grow if you wish to acquire transferrable value. Firms larger than five must be able to demonstrate stable profitability or show profitable growth.

Principal(s) replaceability. This is the acid test because unless a new owner can fill the shoes of the old owner *without excessive client concern* the business has little value, regardless of

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its past success. Firms where principals are directly involved in client service and creative direction are the riskiest to new owners; those where the principals function largely in managing the business are the safest.

Percentage of income represented by the largest clients. This is a crucial consideration. Anything more than 25% downgrades the firm's value. Value diminishes rapidly as the percentage represented by the largest clients increases.

Number of principals. A single principal usually (but not always) indicates a firm too dependent on one person. Two or three principals usually results in a firm with enough delegation of responsibilities to give it staying power. More than three principals often results in ponderous decision making.

Work habits. The more time off principals can take, the stronger the indication that the business can run on its own. On the other hand, when principals have to work excessively long hours to keep the business profitable, it indicates that profitability is being subsidized.

Accounts receivable average. Average age shouldn't exceed 45 days. A higher average usually indicates that accounts receivable are not being well managed.

Debt-to-asset ratio. It should be from .20 to .60. (To determine it, divide assets by long term debt.) A ratio above the target range indicates a greater likelihood of defaulting on debt payments, which are inflexible. In other words, it indicates more debt than can be easily serviced if business takes a downturn. Moreover, if the ratio has been climbing, it may indicate that borrowing is making up for losses that should have been addressed by other means.

Cash reserve. It should average three months of operating expenses (overhead) in *cash*, not receivables.

Billable time. It should be at least 60%, but even more if there is one client representing more than a third of the workload.

WHAT IS PROBABLY BEYOND YOUR CONTROL

Any examination of business valuation wouldn't be realistic without acknowledging that some things are out of a principal's immediate control. Sometimes this works to his or her advantage, sometimes not.

Reputation. It can be changed in the long term by staffing and working procedures, but in the short term it is what it is. A strong reputation affects how much clients will want to work with the firm in the future.

The economy. Some times are good, some times not so good. When things are good, the valuations of most businesses increase; when are not so good, most decrease.

Geographic location. What is the local climate for creative services firms? It may not be the same as the general business climate. And what about competition? Is there little? Lots?

Are there potential buyers? This is the bottom line if the purpose of the valuation is cashing out. Although a stable, profitable company helps create its own demand, no business has *sale* value beyond that of its assets unless there is someone who will at least consider purchasing it. (Note: a business may still have value for other purposes—e.g., the on-going income stream important in divorce settlements.)

WHAT IS REQUIRED

Interaction. A professional valuation is an interactive process—shop principals, the firm's accountant and possibly its attorney, and the valuator. As much as you might like a quick answer, the process can't be reduced to a simple formula. The valuator will want to spend up to a day on site with you. And you'll likely spend

WHAT ARE "YOUR" CLIENTS WORTH TO SOMEONE ELSE?

How much are clients you bring with you worth to a new employer? Probably not much.

The main reason is that there's no guarantee that they'll stick around. They may not be as loyal as you believe, especially when they have to deal with a new situation.

In addition, an employer is not so much interested in the additional income the clients will produce as its *profitability*. And it may not be significant. For example, when you work alone your profit is simply your income minus your overhead. The employer's profit, on the other hand, will come from income, minus overhead, *minus your salary.* So even assuming a clear 10% profit, and that you will bring along $100,000 of new business, their yearly profit (the value of the new business to them) will only be $10,000.

Your new employer will probably be "purchasing" something intangible with minimal profit.

Your talent, your ability to introduce new opportunities, and the marquee value of adding your client names to their client list is your real value. These should all be factors that encourage you to ask for a higher salary than you would otherwise.

It is also reasonable to ask for a sales commission on all business that comes from your clients for one year. 10% to 15% of creative billings and markups is appropriate. After a year, you'll have to accept that the business is now as much theirs and yours.

Finally, if your new employer asks you to sign a non-compete agreement, be sure that it excludes the clients that come with you. Otherwise, you could leave and be contractually prohibited from working with the very clients you introduced to them.

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considerable time on the phone answering his or her questions.

Time. Allow a couple months, start to finish. It will take a week or two to get all the materials together. After that, the valuator will probably take another two weeks to produce a preliminary number. Then another week or two is normally spent in fine tuning. Valuations can be produced in less time, but the cost will go up, or the accuracy go down.

Financial data. Here's what you'll probably need to provide: income statement and balance sheets for the last three to four full years, recast to an accrual basis if necessary… tax returns for the same period… a list of agency gross income (AGI) from at least the top five clients for each of these years (AGI is fee and markup income only)… an aged receivables report with notations describing any debts that may not be collectible… a list of fixed obligations (equipment loans; credit lines; building leases; etc.).

Organizational data. The valuator will need to understand your company's ownership and structure, and access all its legal documents (articles of incorporation, by-laws, buy-sell agreements, etc.).

Distribution information. Provide a list of financial distributions to principals and all shareowners, and indicate all benefits provided.

List of deferred/accelerated needs. Any needs that have been deferred (e.g., replacing an expensive piece of equipment) or accelerated (a purchase of several new workstations for year-end tax purposes), should be listed.

Miscellaneous information. This is the catch all, the subjective, "anything that might impact the value," category. For example, samples of your work… your marketing plans… your competition, your pricing methods… your billable efficiency… key employees insurance… non-competes for key employees… pending lawsuits.

WHAT A PROFESSIONAL VALUATION WILL COST YOU

The purpose of the valuation greatly influences the need for supporting documentation and the time required to do it. The condition of financial data also impacts the price.

As a general rule, a thorough, professional valuation for a creative services company typically runs around $5,000. Later updates by the same valuator typically average $1,500. Updates every one or two years are recommended, especially for a firm with more than one principal.

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Sample Valuation Worksheet

This worksheet demonstrates what we believe to be the best method for valuing creative services businesses. Your business' Net Asset Value (NAV) is its lowest possible value (its equity).

Your business' actual *value is determined by combining Net Asset Value (equity) with Return On Investment (ROI) value. It is calculated by a professional valuator using the formula shown.*

Net Asset Value (NAV) Calculation

Assets:

Vendor deposits:	$_________
Savings:	$_________
Cash on hand:	$_________
Accounts receivable:	$_________
Liquidation value of equip:	$_________
Unbilled work completed:	$_________
Value of expensed items:	$_________
Total Assets:	$_________

Liabilities:

Client prepayments:	$_________
Accounts payable:	$_________
Credit line balance:	$_________
Equipment loans/leases:	$_________
Taxes payable:	$_________
Other debts:	$_________
Total Liabilities:	$_________

NAV value: **$**_________
(Assets – liabilities)

+

ROI value: **$**_________

BUSINESS VALUE **$**_________

Return On Investment (ROI) Calculation

Annualized sales:	$_________		
Less (–) cost of goods sold:	$_________		
Equals agency gross income:	$_________	x 0.6† =	$_________
Less (–) overhead:	$_________		
Equals net profit before tax:	$_________	x 4.0 =	$_________
		Total:	$_________
		Divide (÷) by 2 =	$_________
		(Average of two methods)	

multiply by

General factors

Client dominance*	_____
Marketing plan	_____
Location/market	_____
Product quality	_____
Industry condition	_____

Management factors

Age of firm	_____
Billable efficiency	_____

Institutionalizing factors

Number of principals	_____
Principals' days off	_____
Principals' hours worked/wk	_____

Financial factors

Accounts receiveable age	_____
Debt to equity ratio	_____
Months cushion in cash	_____

Personnel factors

Non-compete agreements	_____
Employee turnover	_____

Average factor _____ → _____

= ROI value

CAUTIONARY NOTE: Principals should use this form only for a rough valuation. In addition to the need for professionally arrived at factors, accurate valuations require adjusting balance sheets and income statements by standard accounting procedures. Without these adjustments, valuations may be off by up to 35% (plus or minus).

*As an example of factoring, the factors used for the percentage of business from one or two clients are as follows: if 1/14 % of income—.80; if 15/35%—1.0; if 35/45%—.80; if 46/55%—.70; if 56/65%—.60; if 66/75%—.50; if 76/85%—.40; if 86% or more—.30.

†The AGI multiplier is based on experience. (0.6 is 4 x 15%, a typical net profit.) Note, however, that using only this figure weights the most recent year. A complete valuation will average previous years to account for trends and dispel anomalies.

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