What’s Driving the Value of

Over 90% of all Companies in the U.S. are closely held and many of these are family-owned businesses. Because there is no liquid market for the equity in these businesses, there is some uncertainty when it comes to determining the value of these companies. While many of these businesses are very successful, the value drivers that contribute to that success may not be well known. Understanding the specific and unique characteristics driving the business value is key, especially when trying to develop a plan to properly position the Company for a liquidity event like a sale or recapitalization. Exploring and understanding what drives business value up-front gives a business owner the opportunity to make strategic decisions and changes to the business that will enable him or her to capture the greatest value when a liquidity event later occurs.

The value of a closely-held business reflects the individual characteristics of the Company, the state of the capital markets, the competitive marketplace and the general economy. Stated differently, both external and internal drivers contribute to value, and the specifics of those drivers will be examined here.

External Drivers

The external drivers that influence a closely-held Company’s value can be grouped into four categories: comparable market activity and valuation multiples, lending environment, economic conditions and the competitive marketplace.

1. **Comparable Market Activity and Valuation Multiples**
   Multiples provide information on how similar companies are performing and valued in the public market and in the M&A deal market. Although it is sometimes difficult to find direct comparisons through valuation research, and a study of related industry information can be a good indicator of value in most cases. Because comparable market activity captures current investor psychology, when investor confidence is high, a business owner can expect to see more healthy deal market activity and higher valuation multiples. Third Party Partial External Sale – Sale of a portion of ownership to a third party buyer.

2. **The Current Lending Environment** can also influence value. Closely-held businesses have less access to capital than their
publicly traded counterparts so acquirers must rely upon bank loans and other more expensive financing when buying or recapitalizing a business. When capital is abundant and inexpensive, a buyer can afford to finance more of the purchase price and potentially pay a higher price for a business while still maintaining an appropriate equity return. Conversely, when capital is scarce, and interest rates are high, a Company's value may be impaired because the buyer will not be able to finance as much of the purchase price and still maintain its expected investment return.

3. Economic Expansion: It is often said that a rising tide raises all ships. The same concept applies to business valuations where it can be assumed in a period of economic expansion, values will tend to be higher, and conversely in periods of economic contraction, values will tend to be lower. The political environment and resulting economic policies drive the health of the economy, both domestic and internationally, and therefore also have an impact on value.

4. Competitive Marketplace: Finally, the competitive landscape within which the business operates can greatly influence the value that can be achieved, especially in the case of a strategic acquisitions. When a closely-held Company has known competitors that can achieve significant synergy with their own operations through an acquisition, the seller is able to demand a higher sale price. Furthermore, if an acquirer sees an advantage to eliminating its competition, it might be also pay a higher price for a business so it has greater share and control of the market.

While a closely-held business owner has little control over external drivers, understanding how these drivers affect value helps determine the appropriate timing for a sale or liquidity event.

**Internal Drivers**

Internal value can be grouped into three categories that are specific to the individual Company: business model, financial characteristics and growth opportunities.

1. **Business Model:** As would be expected, a Company with a good business model will be valued higher than one with a bad model. Attributes reflecting a good business model include brand recognition, unique history, differentiated product and strong value-add capabilities (the latter especially important if the business owner hopes to sell to a strategic buyer). A diverse customer base and a recurring revenue theme are important, as customer concentration and lack of long-term business opportunities create risk and unpredictable revenue streams that can impair value. Finally, the strength of Company's management team is also an important factor when seeking a minority financial investor or financial buyer such as an Employee Stock Ownership Plan (ESOP) because in these type of transactions the management team will remain relatively unchanged.

2. **Company Financial Characteristics** are also important internal drivers to value. Recent growth in revenue and profitability, combined with solid, well-constructed
projections help portray the long-term earnings and future value potential of the business. Balance sheet health and future capital expenditures are also important factors to consider because any long-term claims on cash flow can have a negatively impact on value. In addition, analyzing company performance during a recession or economic contraction is helpful to understand specifically how those economic conditions should weigh in the valuation of the entity is also important to understand what drives value.

3. **Future Growth Opportunities** positively affect a Company’s value. These growth opportunities can enhance revenue, increase cash flow, or mitigate other risk-factors, all of which can have a positive effect on Company value. Revenue can be improved through organic growth, acquisitions, internal product expansion / acquisition or geographic expansion. Cash flow can be improved by pursuing higher margin opportunities and reducing overhead or decreasing capital expenditure needs.

Unlike external drivers, a Company has greater influence and control over internal drivers of value. Therefore, it is wise to analyze and understand these drivers in advance of the liquidity event to develop strategies that can be implemented to use the internal drivers to positively increase value. Taking advantage of the moment when the external and internal drivers are both at an optimal point will enable the business owner to achieve the greatest value for the business.

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