

Selling a closely-held business?

By Karen A. Monfre, CPA/ABV, ASA

The last two years have had a devastating impact on the stock market. The S&P 500 dropped in value more than 55 percent from October 2007 to March 2009 before rebounding to its current level of about 20 percent below the peak. The stock market, which consists of similar companies to many closely-held businesses, is often considered a proxy for change in value of private companies. Does that mean the value of closely-held businesses decreased 55 percent as well? Not necessarily.

While the stock market is made up of publicly-traded companies that are similar to closely-held businesses, the change in value for a publicly-traded stock is generally more exaggerated than the change in value of a comparable closely-held business. Why?

Since its inception, the stock market has been notoriously volatile. The erratic and sometimes irrational movement of the stock market is driven by the daily investment supply and demand. As the demand for stocks/investments increases, so does the stock market and the relative average price/earnings (“P/E”) multiple.

Chart 1 shows the historical average P/E ratios for the S&P 500. Clearly there have been some big spikes and contractions in the P/E ratios over the past 90 years. Some fluctuations have coincided with the economic environment but not all have mirrored trends in the economy. The largest spike in the 1990s was precipitated by the popularity of the 401(k) and the tech bubble later in the 1990s.

The multiples for closely-held businesses have been less volatile than those of the stock market as evidenced by transaction data of companies with deal values up to \$100 million. The average enterprise value to EBITDA multiple paid in these transactions over the past 12 years is shown in chart 2.

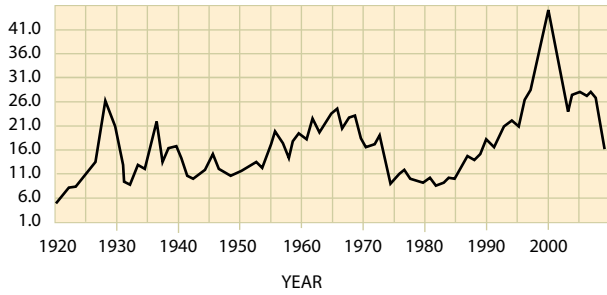
As the two charts illustrate, the movement of the transaction multiples is not as volatile as the stock market, but it still fluctuates. This fluctuation in multiples that occurs in both publicly-traded and privately-held companies is driven by future expected earnings, financing available, supply/demand, and risk/uncertainty relative to future earnings. As each of these factors increases or decreases, there is a direct impact, positive or negative, on the value of the business.



It is important to understand what impact the current economy has on value

Chart 1

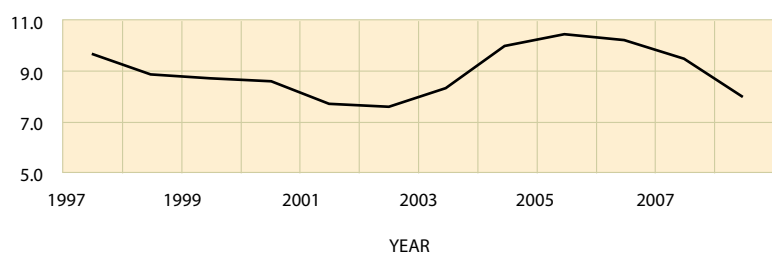
Average P/E Ratios based on S&P 500



Source: S&P LCD Data

Chart 2

Average Multiple for Middle Market M&A



Source: Mergerstat

Future expected earnings

This is the first and foremost factor that drives the value of a business. Although historical earnings are normally considered in any business valuation, future earnings are what drive value. With the downturn in the economy, company profits have suffered and are expected to continue in a slow recovery. This decrease in expected future earnings impacts the value of the businesses. In addition, lower-growth potential also results in lower multiples.

Financing available

Under the current credit tightening, the average amount of financing available per deal has decreased requiring higher equity contributions. This, in turn, will decrease the selling price of a closely-held business because buyers may be unwilling to put more equity in acquisitions and thus reduce their rates of return. This essentially decreases the multiple of earnings paid. In order to maintain the same investor return, price must come down.

Supply/demand

The number of potential buyers also impacts the multiple. As the supply of buyers increases, so does the price. In the 1990s, venture capital firms joined strategic buyers in actively acquiring closely-held businesses. This increased the demand for closely-held businesses and contributed to higher average multiple paid. Due to the tightening of credit markets, the ability of virtually all buyers to get deals done has diminished in the last year. Additionally, with high unemployment rates, the number of individual buyers capable of buying businesses has also decreased. These factors in turn have decreased selling prices and the related multiples of earnings.

Risk/uncertainty relative to future earnings

Uncertainty can affect the purchase price of a business. When there is uncertainty about the future or a higher risk that future results will not be achieved, expectations of the future are lowered, and so is the price a buyer is willing to pay for the business. Before the current economic downturn buyers had a very different perception of risk than they do today. Risk and uncertainty has an impact on the multiple paid and the value of the business at that point in time.

Preserving value

While closely-held business values do not fluctuate with the same volatility as public markets, they do fluctuate with the results of business profits, business risks, financing markets, and overall supply and demand for businesses.

The key to preserving value is to maximize sustainable long-term profits and mitigate risk to the extent possible. Those businesses that have lost money in the last year must find a way to return to profitability or they will see their equity value erode quickly. Businesses in strong cash positions with longer investment horizons might consider an ac-

quisition or investment, taking advantage of lower prices and in some cases certain tax incentives.

The market will return, for both public and private. Focus on managing that which is in your control including business risk, company profits, and the company's leverage.



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