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VALUATION observations

Seven "*Hidden*" Factors that Affect Company Values

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Most businesses are complicated. As a result, assessing the financial value of a business is also complicated, which is why the services of an experienced valuation expert are often needed. There are countless factors that a valuator considers when valuing a business. Some of these are self-evident, whether or not you've ever seen a valuation report. Of course, a valuator will assess certain characteristics of the business, including products and services offered, industries served, key management, etc. The valuator will analyze the subject company's financial statements (to get a grasp of historical performance and the current state of the business). The expert will also formulate, often with the help of management, financial projections for the company, under the premise that the value of a business is directly related to its future performance capabilities. Lastly, the expert will also evaluate the size of the ownership interest to be valued, mostly as it relates to a control or minority position in the subject company.

While these factors may be fairly obvious to financially-savvy businesspersons, there are other not-so-obvious factors that valuators consider as well. The factors discussed below, while they may be overlooked by managers or others, will be given proper attention by a quality valuator:

- **Company-Specific Risks:** Business risks can impact a company's cash flows as well as its general health. Aside from normal business risks, such as the risk of an economic recession, there are company-specific risks. These risks are called non-systematic business risks in the financial world, and one of the most common risks for mid-market private companies is key management risk - when a company is dependent on a few key individuals or suffers from a general lack of management depth. Other company-specific risks include key customer risk (if the business has only a few major clients), key supplier risk, pending litigation, unnecessary debt burden, etc.

- **Working Capital Management:** Cash flow is the primary driver of a company's value. Cash that is tied up in current assets such as accounts receivable or inventory is cash that cannot be distributed to shareholders, and may result in the need for additional debt financing (which would also impact value).

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Seven "*Hidden*" Factors that Affect Company Values (continued)

- **Upcoming Capital Purchases:** In a similar vein, cash that will be needed for a large capital purchase (such as a building addition or a major piece of equipment) is cash that cannot be distributed. It will be important for management to determine whether the rate of return for such an expenditure justifies its purchase.

- **Other Classes of Equity:** Stock options, warrants, phantom stock, and other equity-based incentive compensation, can dilute the value of a company's common stock. Stock options can cause dilution even when currently out-of-the-money (a popular misconception).

- **Shareholder Policies:** A discount for lack of marketability is typically applied to an ownership interest in a private company (particularly non-controlling interests). There are certain shareholder policies that can often enhance or detract from a stock's marketability. The existence of a buy-sell agreement (or another vehicle by which a shareholder can achieve liquidity) enhances a stock's marketability and generally leads to a lower marketability discount. Similarly, a distribution policy that provides shareholders with a meaningful, consistent return on their investment also enhances a stock's marketability.

- **Existence of Potential Buyers:** Similar to buy-sell agreements and a shareholder-friendly distribution policy, the existence of potential buyers of the subject company is beneficial to shareholders, particularly minority-interest shareholders. The availability of potential buyers shortens the expected holding period for an investor and increases the likelihood of a liquidity event. Which companies have the most potential buyers? Often those in industries that are targeted by private equity investors or subject to consolidation trends.

- **Public Stock Performance / Interest Rates:** A tried and tested economic principle states that the price of a good is influenced by the availability of substitutes. If a potential investor in a private company has more attractive options available (such as a high interest rate on a bond or booming public stock prices), the investor is willing to pay less for private company stock.

To maximize your business' value, discuss with a valuation expert the key factors that influence it.

This article highlights the fact that many factors contribute to (or detract from) a company's value. Of the seven factors discussed above, the top five can be influenced by the decisions of management and/or shareholders.

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Seven "*Hidden*" Factors that Affect Company Values (continued)

To maximize your business' value, it would be prudent to discuss with a valuation expert the key factors that influence it. GBQ Consulting has significant experience valuing businesses, business interests, and intangible assets for numerous purposes. The authors can be reached using the contact information below.

ABOUT US

GBQ Consulting is a national valuation practice with offices in New York (NY), Philadelphia (PA), Columbus (OH), and Indianapolis (IN). Our valuation professionals have extensive experience in the valuation of businesses, business interests, and intangible assets of both privately held and publicly traded companies in a broad range of contexts, including:

- Transaction Support & Opinions
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- Financial Reporting
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- Dispute Advisory & Forensic Services

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