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Developing a Formula for Value

I am often asked to help develop or evaluate a formula for setting the value of a business in the future, usually as part of some type of buy-sell agreement. Occasionally the same request is made for determining the future market value of a specific piece of real property and often, a formula is used to predict the future value of equipment subject to some type of lease. A formula can have a real benefit in that various parties understand how the future value of their investment will be determined. The problem is reducing the future value determination of a business, real property, or equipment or for that matter, virtually any other investment, is very difficult as many things change over time.

Many investors look at a multiple of EBITDA "earnings before interest, (income) taxes, depreciation & amortization" as THE way to determine the value of a business. In a similar manner, real estate investors often use a "typical cap rate" to set expected value of a property.

Here are a few issues that should be considered if relying on an EBITDA multiple formula for a business value:

- Capital expenditures needed to maintain sales are assumed to be made as needed. If a business stops reinvesting or defers needed capital expenditures (usually done to maximize the amount of cash that the current owner(s) can withdraw), the value of the business will be damaged yet the EBITDA multiple is unaffected.
- Debt can be maxed out, sometimes much more than it should, to the detriment of the business without affecting the EBITDA multiple.
- Working capital problems are not apparent from an EBITDA multiple. The classic way to increase sales quickly is to relax credit requirements and terms. Selling to deadbeats will increase sales … for a time, but create many problems for a business. Working capital issues are also not apparent when using only an EBITDA multiple.
- Customer concentration issues do not impact EBITDA multiples, yet a company that derives 70% of its sales from one customer is highly likely to be worth a lot less than a company that has its sales spread over many more customers.
- Actual sales in the market may show increasing or decreasing multiples based on a number of factors such as changes in the industry, increased or decreased competition, and technological changes.

EBITDA multiples, or any multiple for that matter, are like rules of thumb – they are based on averages and ignore many specific factors. It should be remembered that not everyone has the same size thumb! Multiples may get you in the ballpark, but there is a big difference between seats behind home plate and those behind a pillar in the top row out in right field. Both are "in the ballpark" but there are some real differences in the desirability and cost of each.

Real estate cap rates change over time and should be influenced by a number of factors relating to the condition of a specific property and its expected future income. Some factors to consider include:

- Prevailing interest rates and whether interest rates are expected to rise (as is currently the case), remain stable, or expected to decline.
- The quality of the property's existing tenant(s) and the length and terms of the lease(s).
- The condition of the property compared to similar properties.
- Is the property being maintained or does it have deferred maintenance, i.e. carpets need to be replaced, painting needed, new roof, etc. Is there a reserve made for needed replacements in setting the cap rate?
- Is the area in which the property is located improving, stable, or declining?
- Are existing rental rates above, at, or below market? Does the lease terms call for rent increases and if so, are they based on the market or are they some type of fixed rate increases?

These mentioned issues are only a few of those that should be considered. While it may sound totally self-serving for an appraiser to state that the best way to set a future value is to have the asset appraised, I truly believe that use of a formula is often dangerous as formulas usually derive a value that is considerably below or higher than the value determined by a competent appraiser.

Formulas will continue to be used in many agreements for a variety of reasons. I understand that this is simply a fact of life. However, parties to agreements containing formulas should be aware of the risks associated with them. Professionals that select a formula for an agreement should also be aware of the risks should a party to an agreement dispute the concluded value derived by the formula in the future and look to the professional for damages. I have seen such things occur a number of times – usually when the asset is sold shortly after the investor is bought out according to the formula for a much higher price.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

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