

Business Transition *In Focus*

What You May Get Wrong About Business Valuations

Business valuations are important to successful planning. They tell you what your business is worth to a potential buyer. Though business valuations seem simple on the surface, even the smartest and most successful business owners can misinterpret their importance.

Business valuations generally tell you two things. First, they tell you whether you can sell or transfer your ownership, right now, and achieve financial independence. Second, and more importantly, they tell you how much more work you must do to build your business' value to achieve that financial independence.

Financial independence is the most important goal of planning for your business' future. Other goals are important. But by definition, an Exit Plan must give you financial independence to be successful. It's likely that your business is the most valuable asset you hold and thus will play a huge role in achieving financial independence. Knowing what it's worth and what you must do to build its value is commonly the bedrock of a successful plan for the future, whether you intend to exit or keep your business forever.

Consider the story of Luca Montez, a business owner who made some common mistakes about business valuations, and how his mistakes affected his planning.

Luca Montez had owned his widget company, MontezCo, for 35 years. He was an integral part of the company's success. When his acquaintance and friendly competitor, Julia Deming, told him that she was selling her business, Luca started thinking about his own retirement. He was very excited to learn that Julia received \$6 million for her business. He saw their businesses as similar and figured he could get that much, too.

Julia offered to put him in touch with some of the advisors that had helped her, but Luca politely declined.

"No, that's too expensive I bet. I know what my business is worth now. I think I can handle it."

Luca decided to put his business on the market. The highest offer he received was for \$2 million, much lower than what Julia had been offered. He became frustrated and asked Julia to put him in touch with some of her advisors.

When Luca met with the Advisor Team, he vented his frustrations.

“My company is bigger than Julia’s. I work with some really well-known customers. I put a lot of work into making this business successful. Why am I not getting the same \$6 million as Julia, if not more?”

After a few meetings and a lot of questions, Luca grudgingly agreed to get a proper business valuation. He had resisted for quite some time because he was convinced that his company was as valuable as Julia’s, and he didn’t want to pay for a formal “opinion of value” at top dollar. His advisors instead suggested that he get a less expensive “calculation of value” from a business valuation specialist.

Using a calculation of value process, Luca’s business valuation specialist said that Luca’s business was currently worth \$2 million, just as he had been offered. She explained that the company had three glaring weaknesses.

- 1. It was too reliant on Luca for its cash flow.*
- 2. It worked with three well-known customers, but those companies represented 80% of MontezCo’s annual sales.*
- 3. It didn’t have a management team that could run the company without Luca, so a buyer would be stuck with Luca for several years or provide their own management team.*

Once Luca learned these facts, he and his Advisor Team knew they needed to get to work. They began to install next-level management. This made the company less reliant on Luca. The management team also knew how to diversify MontezCo’s customer base. As the company grew, Luca created incentive plans to keep his best managers tethered to the company, with help from his advisors. It took several years, but Luca managed to build his company’s value and get the \$6 million he wanted and needed.

Business valuations can guide you toward several answers about the future of your business. Perhaps most importantly, they can tell you where you are financially, which can guide you toward what you must do to get to where you want to be.

If you’d like to talk about strategies to position yourself to achieve financial independence through your business, please contact us today. Call me at (216) 592-7314, send me an email at kprather@financialguide.com, or visit www.TransitioNextAdvisors.com.

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