

Determining Business Value

Whether you own a hot dog stand in Chicago or a national seafood chain, more often than not you have thought about the value of your business.

Every day we think about the value of products and services. At the grocery store for example, it is virtually impossible not to compare the prices of similar products. Many fast food restaurant operators are lowering prices because customers are evaluating dining alternatives on the basis of perceived value.

DIFFERENT VALUES. Just as it is human nature to choose between products based on their relative values, so it is natural for different people to ascribe different values to businesses. Unlike consumer products, restaurant businesses are not so easily compared. For example, it is much easier to compare the value of two automobiles than the value of two eateries. Aside from style, taste and all those subjective determining factors, businesses just do not compare readily with one another.

How then is a business owner, a potential buyer, a lender or an investor to decide when making an important but common decision? To explore the concept of valuation one must understand a few of the basic principles of value and the need for a valuation.

Remember the old adage, "Beauty is in the eye of the beholder." In acquisition terms, it means that the seller of a business may put a different value on the business than will a buyer. A lender, alternatively, may look at the value of a business from a liquidation value standpoint. This does not mean that one person's concept of value is right and the other's wrong. It merely points out that value is subjective and, therefore, very personal.

Scholars indicate that there are three major categories of value: social value, ethical value and economic value. Social value is the recognition accorded by all groups to goods or services. For example the Statue of Liberty is not valued in economic terms but rather in social terms. Ethical value rests upon the moral and religious rules and customs of our society. Finally, economic value is measured in terms of the holder's relative satisfaction with a product or service being evaluated. Economic value can be determined in either an informal or formal marketplace.

Economic value, unlike ethical and social values, is of primary interest to business owners when confronted with the decision to value a business. Most merger and acquisition specialists will attest that social value plays an important role in the sale of high profile restaurants and well-known consumer products.

PAYING EXTRA. Often times, it is the perception of social value that encourages a buyer to pay extra "just to get the business."

Business valuations may be needed at many different times in the business life cycle and for a variety of reasons. The reasons for an evaluation include:

- Contemplation of a sale of the business;
- Estate purposes, either before or after the death of a business owner
- Insurance or a loan purpose;
- Justification of deducted values in certain circumstances with the Internal Revenue Service;
- Arbitration and mediation purposes among shareholders
- Establishment of an ESOP; and
- Buy/sell agreements among shareholders.

Two important factors affect how economic values are determined. The first is the element of time. It makes a significant difference whether one is considering the value of a restaurant operation 20 years ago, today or in the future. Conditions, attitudes and consumer tastes change and these changes have an influence on the economic value of an operation. The second important element to be considered is the recognition of risk and the uncertainty of the future. Since expectations about the future affect the definition of value, the reliability or risk of those future expectations has a great impact on the value of the operation.

Several categories of economic value can be used when referring to the same operation. They differ in amount because their basis portrays different circumstances and purposes.

A category found in most financial statements is recorded value. Recorded value is based on the long-standing principle of accounting that values physical and intangible assets shown on the balance sheet in terms of original costs. The principle tends to undervalue the market value of the company's assets. Bankers like to use this valuation method because of its conservative direction.

A second concept of economic value that eliminates some of the problems of the recorded value approach is replacement value. It represents an attempt to determine the current market value of the assets in the company and provides a better view of the company than recorded value. Usually, appraisals from equipment manufacturers and real estate experts are used to determine the replacement values.

Replacement value focuses in on the assets that make up the restaurant operation. It does not take into consideration the earning capacity of those assets nor the goodwill that a restaurant earns through successful operations.

A third concept of economic value that takes into consideration earning capacity and goodwill is the market value approach. Here, value is determined by a buyer and seller in the marketplace. Market value under most conditions is a fair approximation where the operation fits on the value scale within the business community. It is, however, dependent upon the conditions under which the buyer and the seller meet. Market value as an indicator of economic value is most reliable when the restaurant being valued has high appeal and is quite marketable.

CHECK HOLDINGS. Unlike closely held businesses, a publicly traded restaurant chain investor need only check the Wall Street Journal to determine the value of his holdings.

Because of their broad exposure, daily trading activities readily establish the company's market value. In frequent transactions, sales of properties under duress or special arrangements made between parties do not create market values, although the market value particular to one specific transaction has indeed been created.

The most often-used valuation approach in the sale of restaurant businesses is appraised value. Appraisals are used to determine the "fair value" of the property, and aim to establish a selling price where no ready-made market value exists. The appraiser is normally a specialist in making judgments of this sort and is intimately familiar with the supply and demand for these type of properties. This concept differs from market value in that appraised value contemplates the transfer of the business, whereas market value is determined when the transfer actually takes place.

There are several standard techniques used in appraising the fair market value of a business operation. An appraiser might use one or more of these techniques to produce a range of values upon which a specific value can be chosen depending upon the purpose and need for a valuation number. Most often, however, a qualified appraiser will choose the most appropriate method for both the appraisal's type of business and purpose.

BUSINESS FORMULAS. Many valuation formulas exist. Most investment bankers can help select the formula and the multiplier factors in arriving at one or more price ranges for any business. Only rarely does one formula produce the final value price that a willing buyer and seller will transact.

Once the business' statistical value range has been determined, the appraiser considers those factors that might influence the most precise value location on the value continuum. The factors that influence this economic value include:

1. **General Economic Conditions.** The value of some goods and services that relate to nonessential living tend to be depressed with a general downturn in economic activity. Conversely, in times of economic boom, the value of such goods and services, and of the enterprise connected with providing those of a nonessential nature, will tend to rise more than the general levels of value. In the restaurant industry, most white tablecloth restaurants suffer during recessionary times and most fast food restaurants do quite well.
2. **Political Influence.** The most notable recent political influence on the values of businesses has been the enactment of the new tax law. Several factors in the tax law have influenced values, but the most mentioned has been the increase in the capital gains tax rate.
3. **Technological Change.** Many feel that the restaurant industry has few technological advancements affecting valuation. For those in the industry, technology has improved operating efficiencies, made advertising cost more effective and service more attractive. Additional refinements in even the most basic of technologies should have an influence, positive or negative, on the restaurant industry.
4. **The Predictability of Change.** A restaurant chain utilizing old technology may not have as much value as one with state-of-the-art equipment. On the other hand, if one predicts that new, revolutionary changes in consumer tastes will alter the way the market accepts the product, the restaurant chain able to make those changes without destroying significant, undepreciated prior capital expenditures may be perceived by

a buyer as having more opportunity and higher value.

5. The Dynamics of Supply and Demand. Without either a buyer or a seller, no business could be transacted. If you own the only restaurant for sale in a given market and several prospective buyers want to get into the restaurant business, the value of your property naturally increases. Conversely, a buyer's market tends to diminish the value of all the properties available for sale.

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