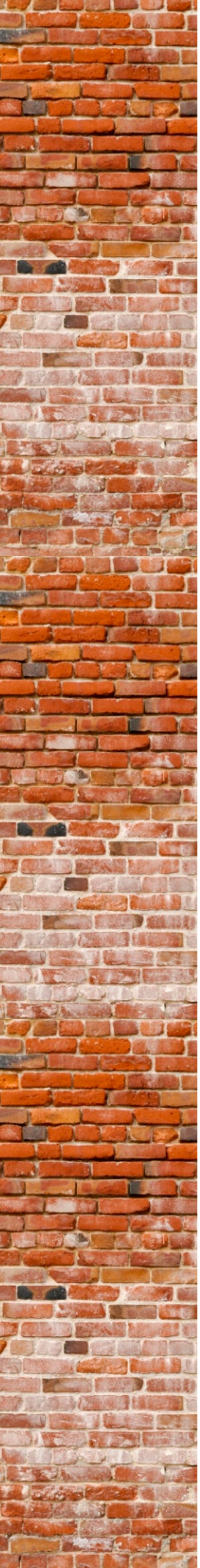

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Transferable Enterprise Value

The Importance of Quantifying Intangible Value Drivers in Small to Medium Size Enterprises (SMEs)

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Introduction

Small to medium size enterprises (SMEs) comprise 99% of all businesses in this country. [1] Over the last decade, they accounted for about 64% of net new jobs annually and approximately half the Gross Domestic Product (GDP) generated by the private nonagricultural sectors. [2,3] SMEs are truly the backbone of the U.S. economy, and a crucial source of jobs for Americans.

Successfully transferring a private business requires the seller to provide the buyer with proof of enterprise value through a reliable measure of future profitability. Intangible assets often turn out to be the hidden value drivers of SMEs, and as such are crucial to their competitive advantage and future earnings.[4] Yet, conventional financial statements do not adequately identify and measure the intangible value drivers in SMEs. This lack of transparency creates an information gap that hinders transfer of ownership. With the majority of SMEs in the hands of baby boomer business owners nearing retirement, the need to transfer private business over the next decade will accelerate. Therefore, finding a workable solution to close the SME information gap and ensure successful transfer of these businesses is critical.

This white paper discusses the importance of quantifying intangible SME value drivers, and lays out a three-point way forward for the public and private sectors to address these issues.

Transparency for now and later: Determining Transferable Enterprise Value

Enterprise value (EV) tries to measure the 'true worth' of a business. More comprehensive than the market capitalization, it is often referred to as the takeover value — the amount of money required for an acquirer to buy a company at current market price, inclusive of cash, debt, and other items associated with a business.[5] To determine EV, which depends in part on whether the business can dependably generate revenue and profit at or above its current rate even without the current business owner(s) in charge, investors and buyers look 'under the hood' of a business and analyze the operations or 'business engine', typically as part of a due diligence process.

Even though calculating EV is an essential part of the business transfer process, there is currently no common framework for quantifying this process akin to GAAP on the financial side of a business.

For publicly traded companies, EV can be derived using GAAP and IFRS. Shareholder reports, financial statements, and other metrics provide organizational transparency sufficient to project future profitability. However, small businesses, many of which are private, find such financial reporting too costly and too complicated to prepare.[6] In recognition of this problem, both the AICPA and the IASB are developing simplified accounting frameworks with privately owned SMEs in mind.[7,8]

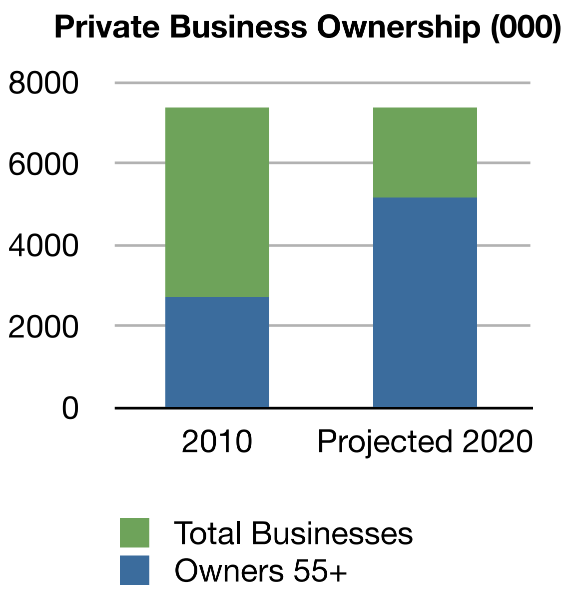
Despite these newer 'SME-friendly' accounting frameworks, the standards still do not adequately capture the intangible value drivers that affect the future profitability of SMEs. This is true for a number of reasons: First, an unknown proportion of profits are attributable to personal relationships among the small business owner, suppliers, and customers. The importance of these relationships is not accounted for in traditional financial statements. Second, operational information critical for transparency is often poorly or only informally documented in smaller firms. Third, SMEs tend to operate in narrowly defined geographic or product markets that make direct comparison for valuation more difficult. Last, in the case of smaller firms, shorter-term concerns such as cash flows often take priority over longer term planning.

Small to medium size enterprises (SMEs) comprise 99% of all businesses in this country and account for over half of net new jobs in the U.S.

These factors affect the transferable enterprise value of SMEs. Whereas publicly traded companies can leverage price discovery mechanisms to uncover their EV, privately owned businesses do not have this mechanism at their disposal. Thus, the information gap is especially pronounced for small companies where intangible value drivers are often hidden and difficult to measure given the lack of a generally accepted valuation framework.

SME Ownership Demographics and Transfer Issues

Exact figures vary, but ownership of privately held SMEs is concentrated in the hands of a generation approaching retirement. In 2010, 70% of U.S. firms with paid employees were owned by baby boomers. In 2020, the youngest baby boomers will turn 55 and more than half will be 65 or over. **It is projected that in 2020 70% of U.S. firms with paid employees will be in the hands of owners 55 years or older**. [9]



Despite being close to retirement, many of these owner/operators do not have a plan for the transfer of ownership. A 2008 survey reports that 96% of Baby Boomer business owners agreed that having an exit and succession strategy is important for their future as well as the future of their business, yet 87% did not have a documented exit plan. [10] This lack of planning further complicates ownership transfer. It is estimated that at any one time 20% of businesses are for sale. It is also estimated of those businesses put on the market with less than $50m in revenue, 80% do not sell; of those businesses over $50m in revenue, 65% do not sell. [11]

Barriers to Transfer have Real Economic Consequences

When a business shuts down, there is a loss of intellectual capital, of infrastructure, and of organizational capital including the relations with the network of suppliers and contacts that allowed the business to function profitably in the first place. A new business will not necessarily spring up overnight to replace the old one. If the business played an important part of the local economy, its demise can have a profound and lasting negative effect on the community. Even if a new one ultimately replaces the old one within the same geographic area, some employees will suffer a spell of unemployment, the costs of which can be large, especially for older workers.

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Beyond this, it is over-optimistic to assume that all the business that was done by the now-shuttered firm will simply transfer to other businesses within the domestic economy. The goodwill embodied in the relations with customers and suppliers may have been all that was keeping the products/ services provided by the business from being imported or outsourced. And of course, the disruption of the supplier-customer network that occurs when a business is shut down can in some cases put the operations of customers and suppliers in jeopardy as well, with a domino effect that creates larger societal losses in the process. These are not trivial considerations, especially from a local or regional perspective.

Ways Forward

The situation described in this white paper is one that calls for a response requiring the participation of both the private and the public sectors. Banking industry, private equity, wealth management and business consultants, as well as accounting professional and their standards-setting committees, can contribute in three important ways. First, by raising awareness of these issues with owner/operators of SMEs. Second, by developing and agreeing to a framework with which to measure value drivers that sustain SME business operations. Third, by providing SME owner/operators with tools to integrate those value drivers into day-day-to-operations, business valuation and continuity plans.

Our next white paper will present a methodology to quantify value drivers in more detail.

[1] SME defined here as <500 employees. Statistics about Business Size (including Small Business) from the U.S. Census Bureau, Table 2a. Employment Size of Employer and Nonemployer Firms, 2008, U.S. Census Bureau, accessed 23 Dec. 2012, http://www.census.gov/econ/smallbus.html

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[10] 2008 White Horse Advisors Survey of Closely-Held Business Owners, White Horse Advisors, LLC, 2008, accessed 23 Dec. 2012, http://exitplanningresearch.com/Findings.htm

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