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Measuring Risks in Privately-Held Businesses

There is an old saying that 'there is no return without risk.' Business owners accept certain risks as a part of their day-to-day existence because there is risk in owning and running any privately held business. Understanding how to measure and compare these risks can assist in understanding how to compare the risks in your business with other risks. In the context of planning a future exit, this is particularly helpful because it helps to shed light on the potential manner in which *value* will be placed on your business by a buyer or successor.

Different Forms of Risk

Risk is measured in many different ways including business risks, risks of product obsolescence, competitive risks, credit risks, market risks, as well as 'opportunity cost' risks – to name a few. However, the most important risks to evaluate are those that an outsider will use to evaluate your company.

Numb to the Risk

Too many business owners, because, they 'live in their businesses', are under the false illusion that the *risk* in their business is 'controlled'. However, the riskiness of any business, as a whole, should be measured more accurately by examining what a buyer or successor would be willing to pay for a controlling stake in that privately held business.

An exiting owner should ask:

- How would an outsider view the risks in my business, and
- What would my business' <u>return on investment</u> be to another buyer?

Outside buyers do not understand the inner-workings of a private business. Therefore, they see risk at every turn. As a result, these investors are typically looking for annualized average returns on investment from a privately-held business of sixteen (16) to thirty-five (35) percent. In fact, sometimes greater returns are required for earlier stage companies.

Converting Return Expectations into Multiples to Get to Value

Another way to look at the expected returns of an outside buyer is to translate the 16% to 35% expected returns selling multiples cash flow, or EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization). Here, the expected returns of 16% and 35% convert into multiples of 2.8 times to 6.25 times the company's cash flow. What this means is that depending upon how much risk a buyer sees in your business, they will adjust their cash flow accordingly.

The Conversion Process

In order to arrive at the conversion of a return expectation to a multiple, you simply divide 100% by the percentage return required. For example, if a buyer expects a 25% annualized return, this converts into a four (4) multiple. However if the buyer sees less risk and only requires a 20% annualized return, then the multiple jumps to a five (5) multiple. This is by no means a comprehensive formula for calculating the value of a business. However, this simplistic method is a helpful way for owners to see how risk converts into what someone will pay for your company.

Why Buyers Lower Valuation When They See More Risk

So why does the buyer of a privately-held company require a 16% to 35% return from owning privately held stock?

There are a number of reasons but the easiest way to understand the high expected returns are due to the *illiquid* nature of privately-held businesses. Unlike publicly traded companies, there is no ‘ready market’ for the trading of shares of private businesses. Therefore, there is no *liquidity* for these investments – which raises the risk associated with owning the business.

As a part of the illiquid nature of private businesses, there is also a lack of *transparency*. In other words, privately-held businesses have no requirement to disclose information about their company to anyone except the government and, perhaps, their bank. In fact, business buyers look at their role as needing to uncover issues that they cannot see before they will take ownership of the company. Experienced buyers look to identify risks before an investment and when they see risks they either lower their valuation or they walk away from the deal entirely.

Concluding Thoughts

Business owners are well served in knowing what the marketplace of buyers thinks of the risks that will be perceive in their business. As an owner, you can create a greater opportunity to achieve a higher value for your business if you can focus on reducing the perceived risk in your business. And, regardless of the ultimate exit option that you choose, being well informed when heading into any transaction is solid advice for any owner.

In conclusion, exit planning can be a complex endeavor for many exiting owners. These plans are not a part of the typical ‘business building’ that many exiting owners are so good at achieving. Applying some of the basic concepts of finance to your privately-held business helps in the process.

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