

UNLOCKING YOUR BUSINESS'S TRUE VALUE: A GUIDE FOR SMART LOAN NEGOTIATIONS



Understanding a company's value is critical when seeking new loans to expand your business or when renegotiating existing terms to be more favorable. It is imperative to understand your financial position and value, especially when dealing with lenders. Your balance sheet provides insight into your company's financial health by detailing its assets and liabilities at a specific point in time.

However, it is essential to note that equating the book value of equity on your balance sheet with the company's fair market value can be misleading. Current market values are often based on a company's future earnings and the prices paid for comparable companies. Thus, relying solely on a balance sheet might not give the complete picture and relying solely on the book value method of valuation can be unreliable.

Book Value vs. Fair Market Value

Let's take a closer look at the difference between book value and fair market value. When lenders consider your balance sheet for loan approvals, they use various metrics related to debt covenants or the underwriting process. Valuation professionals also rely on the balance sheet when applying the cost (or asset-

based) approach to valuing a business. However, there are instances where book value on the balance sheet differs from fair market value.

Certain intangible assets like brand names, patents, customer lists, goodwill, etc., might not be included on the balance sheet, unless acquired from a third party. Yet, these intangible assets can significantly contribute to your company's market value, especially if they play a crucial role in generating earnings (similar to the brand and patent value held by a company like Apple). Contingent liabilities may also be excluded from the balance sheet.

Additionally, under U.S. GAAP, assets are reported at the lower of cost or market value. For example, a building acquired 50 years ago at a company's inception might have a much higher market and operational value than what is currently reflected on the balance sheet.

Other factors that can lead to discrepancies between net book value and market value include accelerated depreciation methods, which tend to underestimate the net book value of property, plant and equipment. Fully depreciated manufacturing equipment might have no value on the balance sheet, but it could still be operation and have some liquidation value.

Accounts receivable may include stale and uncollectible invoices, and inventory might consist of obsolete, missing or damaged items. These irregularities are more likely to occur if your company's financial statements are not audited.

To get a better understanding of your company's true value, it's advisable to compare the net book value with the valuator's conclusion. Identifying the sources of discrepancies between these values can help lenders comprehend what drives value and the differences from historical financial statements. Creating an adjusted or pro forma balance sheet can provide a more helpful illustration.

Future Earnings

In addition to the balance sheet adjustments, future earnings play a significant role in determining your company's value under the market and income valuation approaches. Valuators examine your historical financial statements to determine

trends and review your business plan, financial projections and industry research to assess whether these trends are likely to continue. Factors like new technology or changing regulations can suddenly render a business obsolete or increase its expected growth substantially.

Comparables

When using the market approach to value a company, valuation professionals rely on data from comparable businesses. Although private business sales details are not publicly reported, valuers have access to private transaction databases. These databases reveal historical financial information of transacted companies, including selling prices and terms of deals within your industry.

This information can be beneficial to lenders when evaluating applications for loans for mergers and acquisitions. It also helps lenders understand the current and future outlook of your industry and how your business measures up against competitors.

Furthermore, during the underwriting process, lenders find write-ups about company operations, industry analysis and financial trends informative. Valuers' reports may also disclose informal value indicators, such as previous offers to buy the business or past valuation work completed for securing a personal loan or drafting a buy-sell agreement.

The Valuation Equation

To sum up, the valuation equation includes balance sheet adjustments, future earnings, industry trends and comparable transactions. By arming yourself with this knowledge, you can negotiate with lenders more effectively, increase the likelihood of quick loan approvals, and enhance your reputation as a trustworthy loan recipient. Understanding your company's true value is the key to making informed financial decisions and securing the growth and success of your business.

For more information on business valuation and its importance for loan applications, contact your BMF advisor to help you get a complete picture of

your company's financial position.