# "What's My Business *Worth?*"

## Sooner or later, every contractor asks that question. Earnings, not assets, are the best answer.

**By Don Shelley**

*Assets such as equipment are not valid to use in calculating a company's worth, since they only provide value when used to produce profits. A firm's true worth is measured by its earning power.*

At one time or another, every contractor asks the question: "What is my business worth?" For construction companies, answering this question is difficult because most are privately held.

The owner of a construction-company whose stock is publicly traded need only consult the financial press to determine the value of the stock. For a privately held firm, arriving at the answer is not so simple.

Sometimes owners derive a value for the firm's stock by looking at the value of the corporate assets. In other cases, corporate earnings are used to calculate a number, which often results in a different answer from the asset-based value.

What is more important in calculating a value for a construction company's stock-assets or earnings? While many emphasize asset value, earning power is really the more important factor in determining value. In the absence of adequate earnings, asset value can only represent shareholder value when a company is liquidated.

There are dozens of formulae to determine the value of a closely-held construction company. However, any valuation method must either be based upon asset value or upon earning power.

### Role of Assets

Corporate assets are funded by one of two sources: creditors (liabilities) and owners (net worth or owner's equity). The owner's equity is often called the "book value" of the company. Thus, if a company has a net worth of $1 million and 10,000 shares outstanding, then the book value is $100 per sham.

But is this the value of the company?

Many owners refer to the book value of their companies as being "the value." Book value is simple to compute, readily recognized, and has tremendous intuitive appeal: "If I own $1 million of the total assets on the books, then that's the value."

But despite its advantages and generally recognized acceptance, book value is not necessarily the value of a company. There are several problems with book value:

- Earning capability is ignored.
- Assets on the balance sheet represent historical accounting numbers that may or may not reflect true asset value.
- Any off-balance sheet liabilities or other contingencies are ignored.
- Owner's equity may be understated due to owner's compensation and benefits.

Many companies, particularly those with heavy investments in equipment, have assets whose market value is well above the value on the books (because the company used accelerated depreciation methods). It is not uncommon for equipment-intensive companies to have their fixed assets understated on the books by 25% or more.

If the company with a $1 million book value has an additional $250,000 in equipment value not on the books, does that make the company's value $1.25 million? Not necessarily.

Construction equipment is essentially a commodity item. Except for a few truly specialized pieces, most construction equipment can be bought anywhere, in plentiful quantities.

No one buys equipment because its market value does not fall as quickly as it is depreciated on the books. They buy equipment because it will allow them to generate a profit. Stated another way, equipment only provides real value if combined with materials and labor to produce profits.

If a company with $1 million in book value and $250,000 of unrealized appreciation in equipment can only produce a $50,000 per year profit, the owners would earn only a 5% return on book equity (even less if the market value of the equipment is factored into the equation). While a $1.25 million "value" sounds impressive, a 5% return does not. The local bank pays more than this on simple passbook accounts, with virtually no risk.

If a company cannot produce a meaningful profit with the assets it owns, then its only real value is the "liquidation value" derived when assets are sold. Again, a company may have a $1 million hook equity value and an additional $250,000 of equipment value in excess of book; but it is extremely unlikely a company would actually receive this value were it liquidated. There are numerous costs associated with liquidating a construction company; auctioneers' fees, preparing equipment for sale, finishing or subcontracting the backlog, and continuing overhead while closing the business. All of these costs commonly total as much as 25% of the pre-liquidation value.

**Equipment only provides real value if it is used to produce profits.**

**While many emphasize asset value, earning power is more important in determining value.**

## Importance of Earnings

Since assets can only really translate into stock value when the company is liquidated, then the value of a closely-held construction company must be driven by earnings.

The most common way to measure return is to divide after-tax income by book net worth (also known as "return on net worth:' or "return on equity"). A typical range of return on equity for contractors is 10-30%.

Perhaps the low end of this 10-30% range does not adequately compensate investors for risks associated with a closely-held construction company, given other investment alternatives. But the exact return an investor requires depends upon numerous factors, including the volatility of the earnings, the type of work performed, the abilities and depth of management, and the outlook for the market.

If the owner required a 15% return on the $1 million book value of the investment, the minimum acceptable earnings would be $150,000. If the owner could not achieve these earnings, the return would not represent adequate compensation for the risk. Under these circumstances, it would make more sense to liquidate the company rather than continue operating.

Does this emphasis on earnings power imply that asset value is irrelevant in valuing a contracting business? No. The value of the assets helps sup port the value based on earnings.

In theory, at least, the liquidation value of a company represents the minimum value of the stock. Nevertheless, if a reasonable return on equity cannot be earned, the value of the corporate assets means little to shareholders.

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