DETERMINING THE VALUE OF YOUR NURSERY

by Jim Boyer,

There are many reasons for wanting a valuation of your nursery. The most important ones include: establishing a price to buy or sell; determining the value as collateral for a loan; ascertaining liquidity needs for estate planning; pricing as part of a pre- or post-nuptial agreement; examining the financial condition of the business; apportioning assets in a divorce; calculating federal and state death taxes and gift taxes; calculating income tax valuations for charitable gift deductions.

How much is my business worth? It's a common question, but one that is difficult to answer. Most of use grab a figure out of the air. Some of use base it on sales. Some even expend the effort to determine what a similar nursery recently sold for.

What is needed is a more credible evaluation process. Because valuations are based on assumptions, two parties with the same information can, and probably will, arrive at two different values. Often, the two parties are the owners and the IRS.

To the IRS, value is "the fair market value." This is defined by the IRS as "the price at which the business would change hands between a willing buyer and a willing seller, assuming the buyer is not under any compulsion to buy and the seller is not under any compulsion to sell, and assuming both parties have a reasonable knowledge of the relevant fact." Additionally, the courts have repeatedly based their decisions on this definition.

If a business is being valued for tax purposes, the IRS bases their computations on the concept of the "highest and best use." This means that the business will be valued at the highest amount that can be justified assuming a hypothetical sale using the definition of fair market value. It is very important for nurserymen to understand what "highest and best use" means. For example, let's suppose that you've been running your business for several years. When you started, you closest neighbor was a half-mile down the road. Today, with the addition of new housing developments, road improvements and business growth in the area, you find yourself surrounded. Will the IRS value your business as a nursery or will they assume a much higher value because a developer can put a multi-story office building on the property? The IRS is looking for tax revenue! They will place a value on the property alone that could be several times more the value of your business. They will do this because that is "highest and best use." Unless you have compelling reasons to the contrary, that is the value that will be used in assessing your taxes.

In Revenue Ruling 59-60, the IRS listed eight factors that must be considered when valuing a closely held business. Most of these guidelines also are used when valuing sole proprietorships and partnerships.

IRS Value Factors

Nature of the business and history of the enterprise from its inception. This is a measure of stability, risk, type of operations, quality and quantity of management. Items such as product, market share, growth patterns and changes are considered.

Economic outlook, in general and for the specific industry in particular. The business is evaluated against competitors and against the industry as a whole. The general trend of the economy and the cyclical nature of the business is assessed.

Book value of the stock and financial conditions of the business. The asset value of the business is determined with adjustments to reflect fair market value.

Earnings capacity of the business. This refers to potential earnings capacity. Most buyers look at a business for what it will earn.

Dividend paying capacity. The ability of the corporation to generate surplus cash, after reasonable reinvestment in the business, is evaluated. Most closely held businesses do not pay dividends.

Goodwill or intangible values. This is the amount that a business has earned in addition to what could be expected solely from the investment of its assets. If the assets of a nursery were currently invested in a CD, the owner could expect a return of 8 percent to 9 percent. However, the return on these assets as a business is 12 percent. The difference is attributed to goodwill.

Sales of the stock and size of the block to be valued. The more recent the sale, the more credence is given to its price. Other circumstances considered are the percentage of that which is sold and any recent events that would affect the price (i.e. the gain or loss of a substantial customer or key person).

Market price of similar corporations publicly traded. This occurrence is rare and consequently, it is not often used. While the IRS will use all of the guidelines, three tend to be the most important: book value, earnings capacity and the value of goodwill.

Determining Book Value

Book value is probably the best place to start when valuing your nursery. It is an especially good measure when most or all profit is generated by one person. If this person were unable to generate profits, the only value would be the liquidation value. It is also a good measure if the business is new, highly competitive and marginally profitable, about to merge or experiencing large deficits.

Book value is based on historical data and must be adjusted to reflect the fair market value. Adjustments are critical when a large part of the assets are land and are carried at cost. Adjustments also need to be made to assets that have been depreciated faster than the actual decline in their true value. Potential lawsuits or unfavorable long-term leases should be considered. If the business has difficulty in collecting accounts receivable or if inventory is obsolete or unmarkable, reductions in value are necessary.

After these adjustments, a price per share or the value of partnership interest can be determined. Book value should not be used when evaluating a minority interest with no control.

Determining Earnings Capacity
Earnings capacity is the future value of a projected flow of income. It is a common, fairly simple and reasonably accurate method of valuing a business. To determine a value for the nursery, make a realistic projection of income, choose a capitalization rate, and divide the projected earnings by the capitalization rate.

To determine a realistic projected income, use a five year average of after-tax profits. Add back any bonuses or excessive rent paid. Reduce earnings if salaries or rents were unrealistically low. Ignore non-recurring items. Make adjustments for excess depreciation. Finally, adjust the average if there has been a downturn or upturn in the earnings trend.

When choosing a capitalization rate, use a rate that an investor would be willing to accept for the given risk. A high risk means a high capitalization rate. An older, more stable business with a good capital base and goodwill would have less risk associated with it and therefore a lower capitalization rate. A newer business or one that is dependent on one or two people should have a higher capitalization rate. A higher rate will generate a lower value. To be safe, a range of capitalization rates should be used.

Determining Goodwill Value
Finally, let's take a look at the valuation method that includes goodwill. It is actually a combination of the book value and earnings capacity methods. When we add goodwill to the adjusted book value, we have what is commonly called the "going concern" value. A well-run business should generate a return in excess of what could be reasonably expected from just the use of the capital invested. This excess is goodwill. The going concern value capitalizes goodwill and then adds this value to the adjusted book value of the firm's assets to determine the total value. Goodwill should include reputation, location, quality of management, morale, and market position. Goodwill does not include patents, copyrights or trademarks.

While business valuation may seem somewhat complicated, your financial advisor should have software available to do the calculations. Software will calculate values using several different methods and then give you an average business value. Additionally, use a range of capitalization rates. Ideally, you should come up with a range of values that truly reflects the value of your business. Then, once a year, you can make necessary adjustments and have a realistic, usable value for your nursery. This will give you additional information to aid in planning and reduce your chances of a confrontation with the IRS.

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