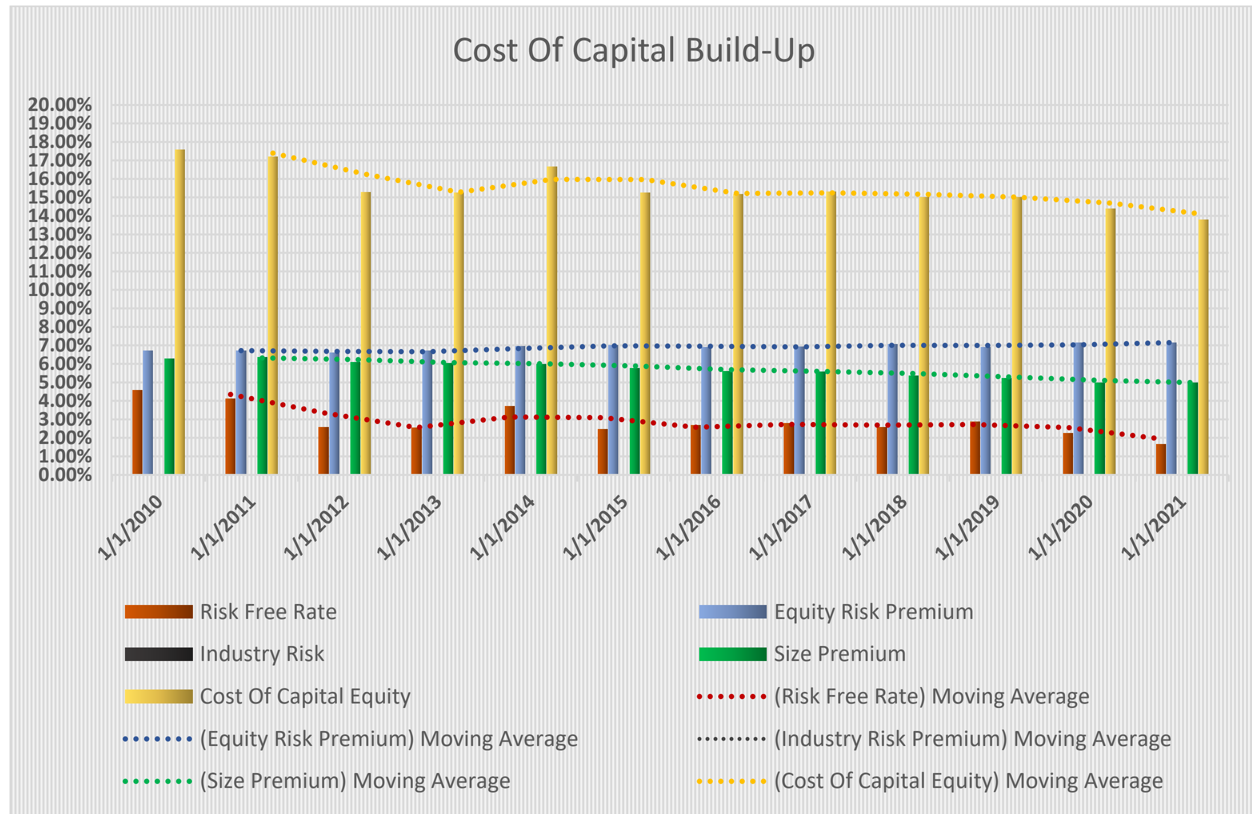
Do Closely Held Businesses have Valuation Risk?

Just another risk metric to be concerned with, right? Often, business owners who operate closely held businesses get inundated by consultants and advisors discussing this KPI (key performance indicator) or that KPI. Many times, these are valid, but get lost in the day-to-day shuffle of life and making things work at their business. They continue to work, day in and day out knowing that one day they will pass along their business to their heirs or sell it and convert the asset to a liquid asset for retirement.

Over the last 10 years, we have seen nearly hundreds of cases of businesses where merely being in existence has created value. Some of these businesses have done nothing but keep up with the inflation metrics spewed by Washington. If you look at the chart below, we have put together a quick example of what is termed the "Build-Up Method". This methodology helps valuation experts put a value on a business. As you can see, the Cost of Capital has dropped from 17.5% to just under 14% using zero for industry risk to keep it unbiased. Although the Equity Risk Premium has advanced, the main culprit of increasing values over the last 10 years is simply the Risk-Free Rate which has plummeted from above 4.5% to nearly 1.5%. The Risk-Free Rate is equivalent to the 20-year Fixed Treasury Rate.



One might say, well inflation has risen 3% over the last 10 years and this may be a fair indicator of the valuation piece. The way this 3% drop in the 20-year Treasury translates is as follows: If a company is worth $1M on January 1, 2010 and they did nothing, but survive and have the same income on January 1, 2020, the business would be worth $1.25M. Your alarm may be going off and say, what about growth, etc. This is a rudimentary explanation of a 25% rise in value of a business over a 10-year period.

Why is this important? Currently, with the rise in rates and spending gone wild in Washington, it is likely the 20-year Treasury continues to rise and this past rise in Value, will start to be a drop in Value, presuming all things stay constant. The reason for writing this quick article is for advisors/accountants to put clients on notice that they will need to exponentially increase bottom line profits greater than the rise in the 20-year Treasury to increase the value of their business. So if we see a 3% rise in the next 10 years of the 20-year Treasury, clients will need a 6% offset of business income increase to see a nominal inflation equivalent rise in business value.

Just something to keep in mind when speaking with your clients about gifting, selling, valuation, net worth, etc.