

Part V

Don't Try This at Home! Turning Things Over to the Valuation Experts

The 5th Wave

By Rich Tennant



"I read about investing in a company called Unihandle Ohio, but I'm uneasy about a stock that's listed on the NASDAQ as UhOh."

In this part . . .

We haven't been shy at all about telling you to get help when you feel that you're out of your depth in any part of the valuation process. Because we think this point is so important, we decided to drive it home in this part by providing examples of three situations that call for professional assistance with the various tasks needed to arrive at business valuation: getting a divorce, estate planning and gifting, and attracting investors and lenders to a business. We say, "Don't try this at home," because we find that unbiased advice is exactly what people need in these situations.

Chapter 19

Divorce

In This Chapter

- ▶ Planning in advance with prenuptial and postnuptial agreements
 - ▶ Understanding what a divorce can do to a family business
 - ▶ Establishing the business value in a divorce
 - ▶ Finding out the importance of valuation dates
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Divorce can be one of the biggest threats to the future of any closely held business, as well as to the people who depend on it.

When married business owners begin a divorce action, whether one party or both parties were involved in the day-to-day business, they set a series of financially threatening events into motion. Children, stepchildren, in-laws, business partners, and employees are affected by these events on both a short-term basis (the split of assets in divorce) and a long-term basis (the distribution of assets among multiple families at the time of a former spouse's death).

In this chapter, we talk about prenuptial and postnuptial agreements, and we also discuss the role of business valuation during divorce proceedings.

Doing Estate Planning Regardless of Marital Status

In estate matters (see Chapter 20), it's a good rule of thumb to review your plans every three years or whenever a material change in your family's lifestyle occurs, such as a marriage, a divorce, a remarriage, the birth of children, the loss of an immediate family member, or a major rise or fall in assets.



Planning for the future of a business isn't just about the possibility of divorce. Proper discussion, documentation, and review of a family's assets — with the participation of the right legal, tax, and financial planning advisors — can keep more of those assets in the family according to the family's wishes.

In the case of a family business, generations of family members may have built careers there or otherwise depend on that income. Yet the business may not even be at the heart of an issue; families may have supported foundations or other charitable activities for years with a certain mission that the people in charge don't want changed.

More than a few families have imploded in ugly legal squabbles over these situations and more. The results can be lengthy legal battles with damaging tax consequences, a potentially unfair split of assets among relatives, or simple mismanagement of those assets going forward.

One should consider all these issues with respect to valuation of the business. As you can see, divorce complicates everything, but it's just one piece of a crowded puzzle of issues involving business valuation, family legacies, and money. In good times and bad, you need to think about all those issues together.

Planning Prenuptial and Postnuptial Agreements

If you watch any TV show with a lawyer in the lead role, or if you're addicted to the divorce blotter in any gossip magazine, you probably know what a prenuptial agreement is. But in case you don't, a *prenuptial agreement* — casually known as a *prenup* — is an agreement made and signed by two people before the wedding to establish financial ground rules during the marriage and to set clear courses of action for marital assets in case of death or divorce.

This chapter is about business valuation in case of a divorce, so why are we talking about prenuptial agreements? Because anyone who's considering marriage while operating or planning to open a business should work with a future spouse to develop a prenuptial agreement. This agreement should set ground rules on the use and distribution of financial assets not only during the marriage but also at the end, either through divorce or death.

A prenup is not about when you'll be sending the kids to bed or who will do the chores. Rather, a prenup ensures a financial balance of power in a relationship. Yes, the agreement is literally about the money, but it also may be about saving pain, heartache — and yes, money — if a relationship ends.



Courts have a long history of looking closely at prenups, because in the past, they were often written in a way that clearly supported the wealthier spouse. Courts can invalidate a prenup, so make sure that both sides get the advice of talented matrimonial law, estate, and business valuation professionals beforehand so that the document will be durable.

A *postnuptial agreement* sets out the same issues and conditions, with one critical difference: It's made after the parties say "I do." A couple without a prenup may consider a postnuptial agreement for a variety of reasons, but determining the future of a family business started either before or after the marriage is just as good a reason as any.



Doing a business valuation before the wedding is a good idea. If the marriage is preceded by a recent divorce, a business valuation from the divorce may be applicable. In any event, if the valuation is more than a year old, it should be updated. The new valuation should be attached to the balance sheet of the business and footnoted as part of the prenuptial record.

Breaking down a prenuptial agreement

Getting a spouse to sign off on a prenup isn't much of a picnic, but creating a breakup agreement years after the honeymoon is an even greater challenge. The prenup process may not be easy to go through — creating a prenup agreement requires both sides to be very honest about how they feel about money — but it represents, at minimum, smart business planning and prescient thinking in case a divorce actually happens.

Here's the full range of financial issues that a prenuptial agreement typically addresses:

- ✔ **Which finances you'll commingle and which ones you'll keep separate:** Depending on your state's law governing assets accumulated during marriage — often called *community property* — a prenup can state exactly how you'll split assets at the end. See the later section "State laws on splitting property" for details on how states regard ownership.
- ✔ **How you'll handle debt coming into the marriage:** If one of you has (or both of you have) sizable personal or business debt coming into the marriage, you want to lay your cards on the table and address how that debt will be allotted in case of divorce.



A good way to start the disclosure process before you start hammering out a prenup is to exchange credit reports — the reports issued by the main credit bureaus, Experian (www.experian.com), TransUnion (www.transunion.com), and Equifax (www.equifax.com). Looking at each other's credit history may be the least romantic thing you ever do, but it's a first, honest step toward a lifetime of transparency in all your financial dealings.

- ✔ **How you'll provide for kids from previous marriages:** The agreement isn't just about the money or business assets you keep for yourselves; it's also about making sure that your heirs keep what's theirs.
- ✔ **How you'll keep family property in the family:** This part of the agreement is particularly important for family businesses intended for children from previous marriages, but it also applies to homes and other forms of property. If property is important, you can and should designate its intended ownership in this legal document.
- ✔ **How your estate goals will align with your other asset goals:** A prenup is both a defensive document against divorce and an important support for the spouses' respective estate plans. A prenup's language should dovetail with both parties' wills, trusts, and health directives.



No important financial agreement is an island. Whether you're talking about a prenup, a will, a trust, or a business ownership agreement, the agreement needs to complement your overall financial plans and goals. In other words, a prenup should address estate and business issues and vice versa.

- ✔ **What both sides will get to keep at the time of divorce:** A prenup can specify what each partner will get — and won't get — in the event of divorce. Depending on the type of business assets and the spouses' willingness to set a baseline value on business assets going into the marriage, a valuation may be done at that time.



Prenups are all about the money — nothing else. If a prenup specifies when and where your spouse can go without you or how you'll discipline the kids, these issues can't be enforced in a court of law. Stick to the dollars.

- ✔ **How money will be handled throughout the marriage:** Are you going to file joint tax returns or separate returns that allocate particular income and deductions? What kind of bank accounts will you have, and who will pay the bills? Is there a plan for buying a house or a business together? A prenup can be as general or as specific about your financial affairs as you need it to be.
- ✔ **What standard of value you'll agree to use when you divorce:** As we say throughout the book, the valuation method you choose is affected by many factors that are unique to you and your business. In general, family-law courts accept fair-market, intrinsic, or investment valuations (see Chapter 3). It makes sense to agree on value methodology at the start of a relationship to prevent an endless debate over methodology at the end.
- ✔ **Full disclosure of all debts and assets as of the marriage date:** Again, it's wise to pull credit reports and other financial data at the beginning.

- ✓ **The status of any gifts or bequests you receive, either before or after marriage:** A good example is a gift by one spouse's parents of a down payment on a house. Is the gift to the couple or just to the donors' child?
- ✓ **The beneficiaries of all retirement plans, such as 401(k)s, pensions, and individual retirement accounts (IRAs), in the event of your death or divorce:** This is particularly important if each individual in the marriage has children by the current relationship as well as children from former relationships.
- ✓ **How you'll handle the day-to-day living, college, and healthcare expenses of your kids:** This can dictate behavior during the marriage as well as intended behavior after a divorce.

Events that void a prenup can depend on state law. In some situations, adultery can void a prenuptial agreement.

Creating a postnuptial agreement

A postnuptial agreement may not be a bad idea for a married couple who is starting a business together but has never addressed the subject of separating assets. To do these agreements well, you need two things:

- ✓ Truthfulness
- ✓ An experienced lawyer to represent your interests

Most states recognize postnups via statutes that allow married people to form contracts with each other. Keep in mind, however, that courts examine postnups as carefully as prenups (which we cover in the preceding section), because some judges believe that certain spouses have less bargaining power after they're married and may be forced into signing such an agreement.

Seeking the Correct Professionals

Divorce is one of the most intense examples of when you need to blend the skills of a number of qualified experts. Remember, personal and business objectives are always linked, and in a highly emotional process like divorce, you need skilled professionals who have the ability to work with others. If your marriage is breaking up, you may need to consult some or all of the following experts and put them in touch with one another:

- ✓ **Valuation professional:** This trained expert values the business based on the parameters you set, and your soon-to-be-ex-spouse may hire his or her own for the same purpose.
- ✓ **Tax attorney:** This legal expert may be among the first experts you consult about the potential tax ramifications of selling or splitting certain assets held jointly, or believed to have been held jointly, in the marriage.
- ✓ **Divorce attorney:** The best divorce attorneys act as ringmasters of all these professionals, blending the results of their work into a successful negotiation for a divorce settlement.
- ✓ **Estate attorney:** Divorce may be the endpoint of a marriage, but it can redirect your financial life and certainly the financial life of your heirs. An estate attorney has a distinct perspective on the valuation and tax questions inherent based on the interests of his or her client.

Looking at What Happens to a Family Business in Divorce

Deep emotional stress and clear thinking about money don't mix. Divorce can spark some pretty colorful valuation scenarios based on what each spouse believes the business is worth. And after emotions spill over, arguments once confined at home can move into the office. For this reason, divorce may rank highest among the don't-try-this-at-home scenarios.

Also, no clear standard of value exists in a divorce situation. (For a review of standards of value, see Chapter 3.) When couples split up and try to determine the value of shared assets in a company, one spouse may try to get the number as high as possible to boost his or her takeaway, whereas the other does everything possible to keep the valuation low so as not to lose too much of what he or she feels entitled to.

This situation can get to be very nasty, depending on the planning (or lack of planning) both spouses brought to the business during their marriage. But make no mistake: Divorce is just as big a triggering event in the life of a business as a natural disaster, an unwanted takeover, or the loss of a major customer.

In terms of valuation, divorce actions can spark a sudden need to do the following:

- ✓ Determine the continuing share of ownership in a company for one or both spouses who want to continue working in the family business.
- ✓ Set a breakup value for a company if the spouses end up liquidating and taking their splits with them.

- ✔ Find ways to protect the estate of the founding family of the business against actions threatened by the in-law family.
- ✔ Take immediate action to calm customers, employees, and suppliers who fear that the divorce action will decimate the company.

Without an enforceable pre- or postnuptial agreement (see the pertinent sections earlier in this chapter), a family business is simply another asset in the marital estate that's subject to distribution after a divorce, so we can't overemphasize the importance of divorce planning before starting a business.

Business valuation gets tough during a divorce for the following reasons:

- ✔ **Conflicting goals:** Each company has complexity in terms of tangible assets such as cash, inventory, tools, fixtures, furniture, and machinery. But intangible issues — ranging from customer lists and patents to various forms of intellectual capital that one or both spouses contributed — may complicate matters even more. Even if a spouse didn't get a weekly paycheck from the business, he or she may consider his or her non-monetary support of the other spouse in building the business as entitlement to a significant portion of the value of the business.
- ✔ **Questions about control:** Depending on where the business is in its life cycle at the time of a divorce, the spouses may have young children who aren't involved in the family business or adult children who have an ownership stake and already have careers in the business. Also, both spouses may be working in the business, though at different levels of seniority. If all adult family members have a stake in the company, they have a stake in the outcome of negotiations for its control.
- ✔ **Inadequate basis for evaluation:** Buy/sell agreements may be adequate to settle partnership issues, but courts tend not to look at those agreements as the final word on the worth of a business, because they tend to serve the interests of the active owner of the business, not the divorcing spouse outside the business.



If you're interviewing divorce attorneys and tax professionals before a divorce proceeding, ask them whether they work with a certified business valuation professional who specializes in divorce. Though no one wants to end up in court, the best valuation experts in the divorce field not only know how to value assets in this situation but also understand state statutes with respect to both valuation and matrimonial law.

- ✔ **Inadequate access to information:** One of the most difficult aspects of valuing a private company involved in divorce is access to critical information that would help the nonactive or less-senior spouse in the business get a better idea of the health of the business. Although not all spouses hide information illegally, many wouldn't choose to make it easy to find.

State laws on splitting property

Keep in mind that where you live matters in determining how property is divided in the event of divorce. Pay particular attention to your state law when developing pre- and postnuptial agreements. You need to work with qualified attorneys and valuation professionals who understand how the law will affect your assets and develop a negotiating strategy from there.

Community-property states

Do you live in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin, or Puerto Rico? These areas of the country are known as community-property states. (Puerto Rico isn't a state, of course, but it has the same law.) In a *community-property* state, each spouse owns an undivided one-half interest in most property acquired by a husband or wife *during the course of a marriage*.

For a business started before a marriage, community-property law isn't necessarily a protection. Businesses tend to grow during a marriage, and unless the inactive spouse legally refuses a right to those assets through a prenuptial agreement or some other document, she or he is unlikely to be shut out.

If the spouse who wants to continue working in the business is challenged by the spouse who wants his or her share, the result can be the sale, shutdown, or dangerous leveraging of the company. Without planning and with significant acrimony, family legacies go down the drain all the time.



Here's one more wrinkle: With women now earning the majority of college degrees and taking time out to rear families, more couples are starting businesses together. In 2002, MassMutual Financial Group and the Raymond Institute reported that husband-and-wife chief executive officers (CEOs) of family businesses increased from 8 percent in 1997 to 14 percent in 2002. Both spouses need to think seriously about property while the relationship is healthy.

Equitable-distribution states

No matter how much you plan and no matter how much you do to protect what you believe to be yours, state legislatures have put their own spin on what your settlement will eventually be. In certain cases, judges apply their own interpretation of what a fair distribution of assets should be.

In most states, property is classified as being either separate property or marital property. *Separate property* includes property owned before the marriage, inherited during the marriage, received as a gift during the marriage, or otherwise excluded from marital property by a prenuptial agreement. *Marital property* is all other property acquired during the marriage, no matter which spouse owns it.

Nine U.S. states and one U.S. territory follow community-property law (see the preceding section), which essentially means that property or assets acquired by the husband or wife during the marriage (with the exception of certain inheritances and gifts) are owned 50/50 by the husband and wife.

In *equitable-distribution* states, all property, whenever or however it was acquired and regardless of its legal title, is subject to equal or unequal division. The definition is a bit of a wild card. In some states, if your spouse got a big inheritance before you walked down the aisle and he never touched those assets for family use or investment, a judge may have the right to divide those funds between the two of you. If you're talking about a marriage that lasted only a year or two, you could be looking at a pretty unequal settlement — at least from the standpoint of the person giving up the money!

Wherever you live, your state's divorce laws indicate specific factors that judges need to follow to make an equitable division of property or award of alimony. Some states also allow discretionary factors that allow judges more leeway in their decision-making. Following are some of these factors:

- ✓ The length of the marriage
- ✓ The ages, health, and occupations of both parties
- ✓ Lifestyle issues, including issues related to children
- ✓ Each party's contribution to the marriage in terms of money issues (wages, investments, and so on) versus domestic contributions (homemaking, child rearing, and so on)
- ✓ The behavior of the parties during the marriage
- ✓ The employable skills of both parties

As you can see, judges do have a lot of power in the divorce-settlement process, so both parties in a divorce need to be aware of how state law will affect what they're likely to keep in a divorce. That knowledge may influence valuation efforts during the divorce.

The marital balance of power

Justin L. Cherfoli, managing director of the Dispute Advisory and Forensic Services Group at Stout Risius Ross, a Chicago-based law firm, regularly works with both sides in a divorce — business owners and their spouses who aren't active in the business. "If there's one thing I've learned, it's that whoever controls the finances of a business holds all 52 cards in the deck, and they don't give out more than they feel they have to," Cherfoli says.

Those who aren't on the side with the cards definitely need valuation expertise to counter any valuation estimate offered by the spouse who is active in the business. Cherfoli says that many valuation clients don't always

like the results because valuation professionals are supposed to value the business independently and without bias — even if that means upsetting the person who's paying the bill. "A valuation professional's job is to provide an honest investigation and appraisal of the business. Sometimes a client may or may not be happy with the results," Cherfoli says.



Valuation professionals have another excellent reason to focus on the valuation assignment and not the client's wishes: They may have to defend their opinions in court. Many valuation professionals spend significant time in court defending valuations that clients hired them to do, and in some cases, the courts themselves hire valuation professionals to review situations independently before a judge or jury makes a decision.

Information — and the availability of it — separates a divorce business valuation from any other business valuation, according to Cherfoli. In a typical business valuation that's aimed at a strategic purchase or sale, both sides are generally willing participants in the process, because they want a deal to happen — or at the moment, think they do.

In a divorce, however, the conflicts inherent in the breakup of the marriage tend to seep over into the business-valuation process. If the parties have an absence of trust, a possible corresponding absence of information will force the valuation professional to do more digging and investigation than she would have to do in a friendly situation.

Divorce valuations can be such a challenge that spouses outside the business may consider hiring a forensic accountant to determine whether information is legitimate or even available. (We discuss forensic accounting in detail in Chapter 17.)



If the business paid the nonactive spouse a salary, the court may want to know whether that spouse was paid fairly for his or her work, so it's important to have an idea of what ordinary employees would be paid for such work. If the parties agree, or if a court rules that a spouse is due extensive back pay, that ruling is going to affect the overall settlement — and in some cases, the overall value of the business.

Determining the Business Value in a Divorce

People devote their lives to building companies, so they're bound to have an attachment to the business that goes beyond simple numbers. As we say earlier in this chapter, valuing a business in divorce isn't just about the present value of that business; it's also about the growth prospects for that business and how the family will — or won't — continue to be involved after the divorce.

The following factors can establish the value of a business in a divorce situation:

- ✔ **Loyalty to the business:** Even if the spouses are no longer loyal to each other, one or both may still want to operate the business. Some people can go from being soul mates to being strictly business partners, but that transition requires serious planning and ground rules — financially, operationally, and personally.
- ✔ **A desire to cash out and go:** One spouse may just want to sell the business or negotiate a buyout so the departing spouse can use the cash to fund living expenses or possibly to start a new company.
- ✔ **The need to take care of the kids:** Whether the children in a divorce are toddlers or young adults, both parties in a divorce may seek valuation advice not only to address their immediate goals but also to make sure, if the business is going to continue, that it can support the children. If the business is *not* going to continue, proceeds from the sale of the company need to be invested for the kids' education or other goals.
- ✔ **Retirement issues:** If one spouse has (or both spouses have) money tied up in the company's pension plan, both parties must discuss what will happen to the plan if one spouse decides to remove his or her money or transfer it to another retirement vehicle.

Keeping Valuation Dates in Mind

One of the most critical considerations in divorce-related business valuations is the date on the calendar — not so much the date today but the date on which you and your soon-to-be-ex agree that you're going to set the valuation for the business.

What's the best date? Good question. Only you and your attorneys, tax advisors, and other experts can select good candidates. Ultimately, however, it's your job to pick the valuation date, not a valuation professional's.

Generally, your choices, which may be combined or averaged, are as follow:

- ✔ The date of your marriage
- ✔ The date of your legal separation
- ✔ The date you filed for divorce
- ✔ The date your divorce trial started (if you're unfortunate enough to have to go to trial)

The date you agree on for the valuation of the business can lead to a tremendous advantage for one party and a disadvantage for the other. The right choice depends on both parties' cash needs, tax situations, and nonmonetary issues that shaped the decision to divorce in the first place. If your spouse is getting a house — and the expenses of running that house while losing his or her job at the family company — you have a new set of financial circumstances to address.



If you're working with a valuation expert, divorce attorneys need to advise that expert of the valuation date early in the game so she can work with the clearest information possible.

In a divorce scenario, the same methods are used to value a company. The only twist is that given the jurisdiction, the valuation professional may be directed to use a certain standard of value and/or valuation date, which would lead to a different conclusion of value than if the valuation were being done for some other purpose. In essence, however, the goal is the same as in most any other valuation: to determine what the value of the company would be if it were sold on the open market.

You often hear the phrase *intrinsic valuation* applied in a divorce largely because of the contributions that the spouses made to the business. The spouse who wants to retain control of the company may downplay certain aspects of intrinsic value — intellectual property that could yield huge product advancements later or a brand identity that's just taking off, for example — because he or she doesn't want to hand off too much value in the negotiation. That strategy isn't illegal unless that spouse is deliberately hiding documents or other proof that this potentially large center of value exists. *Intrinsic value* implies having more proprietary knowledge of a company and its operations than an ordinary investor may possess. Good negotiators never want to give too much away.

By the way, it's possible to oversell a company's intrinsic value. This fact is what makes business valuation an art as well as a science (a topic that we discuss in Chapter 3).

Chapter 20

Estate Planning and Gifting

In This Chapter

- ▶ Planning for unexpected family problems
 - ▶ Creating succession and estate plans
 - ▶ Getting expert help when you need it
 - ▶ Working with buy/sell agreements
 - ▶ Setting up a gifting strategy
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When a company plans for any kind of ownership transition, business valuation needs to be part of the process. If the company is changing hands between strangers or nonfamily members, both sides have a certain idea of value that they want to confirm before the negotiation starts. Settling on a price only after a thoughtful and thorough analysis of what the company is actually worth makes sense.

Surprisingly often, however, valuation is neglected when a business asset is passed down within a family. Often, a patriarch builds a company from scratch, runs it his way, and expects family members to take the operation blithely into its second and third generations without giving any thought to the real value — or possible lack of value — of what he's built. The owner's perception of value may not match his children's perceptions or the perception of the marketplace. This lack of objectivity — or at least reluctance to bring in an objective expert to value the business — causes many businesses to shut down or go up for sale before they make it to the next generation.

If a founder is passing down his company to his kids, both sides — the founder and the heirs — are wise if they insist on an independent and early valuation process to get an idea not only of what the business is worth but also of the tax implications of the transfer.

Proper estate planning requires the entire family to do something that most families find quite difficult: leaving egos, history, and emotions at the door as they determine what their business assets are really worth. In this chapter, we discuss succession and estate planning, gifting, and valuation as it relates to buy/sell agreements.

Succession Planning: A Critical Part of Business Planning

We talk about exit plans in many valuation situations for a reason: Exits are common facts of life, whether or not business founders want to admit their existence and certainly whether or not the founders want them to happen. Founders die in the prime of life, business partners get sick of working together, and kids decide they don't want the family business. Economic and industrial realities change, and suddenly, founders are forced to survive in ways that they hadn't planned.

Exits can — and should — be planned, and business valuation is a critical part of exit planning (for more on exit planning, turn to Chapter 2). But exit planning is tough to do. Most business founders are too tied up in the day-to-day activities of running the business to spend a lot of time thinking about how to pass on the business to children or employees.

Think about the ending in the most positive way possible: in terms of the startup and continuation of the business.

Considering Family Matters

Family businesses typically are small businesses — companies with annual revenue well under \$1 million. The business revenue may feed and clothe a household of immediate family members and relatives, as well as educate them and provide them with summer jobs and full-time careers.

Family businesses, however, aren't forever. Only 30 percent of family businesses are passed down to the next generation. These closely held businesses often fail to outlive their founders. Add that fact to the threat of estate taxes and the job of finding competent managers and employees inside and outside the family to keep the business going, and you can see why business survival is such a challenge.

Anticipating problems

Challenges in passing the family business to the next generation can involve anything from tax issues and founder reluctance to family conflicts and drama. Succession planning and valuation are necessary parts of estate planning if the founder wants the business to continue.

Thorough planning can help owners anticipate and avert problems that can threaten the business over time, such as the following:

- ✔ **Personal conflicts:** Siblings or other family members who always had a role in the business may resent the people who haven't but who still believe they're entitled to an ownership stake. Estate planning and valuation can provide a basis for open discussion within the family and allow the founder to outline an equitable division that won't be a surprise to the parties involved.

Also, relationships forged in childhood don't always translate into effective working relationships in a shared business concern.
- ✔ **Marriage:** A marriage may occur after the business is launched. Estate planning becomes an ever-widening activity after this event, because new spouses or children may — or may not — be considered to be heirs to the estate.
- ✔ **Divorce:** Divorce breaks up more than a few family businesses (see Chapter 19 for info). After a divorce, a new estate plan needs to address which family members — or former family members — will inherit the estate. Both parties in a divorce frequently do valuation if a family business is involved as a prime asset.
- ✔ **Death:** When a founder dies, a family can go to war for reasons far more emotional than economical.



No estate or succession plan should be made without a commitment to reevaluation when major life or business events happen. Death, incapacitation, marriage, divorce, mergers, sales of divisions, and departures of key executives are good triggers for revisiting an estate plan to make sure that it properly represents the wishes of the business owner.

Considering blended and nontraditional families

Fifty years ago, planning for the future of a *multigenerational business* — businesses in which several generations of a family participated at all levels — was a complicated task in its own right. Usually, though, all the people involved were blood relatives.



The U.S. Census Bureau reports that blended families and stepfamilies are common in America today. Roughly 50 percent of all first marriages end in divorce, but the breakup rate for second marriages is even higher: more than 60 percent. At the same time, the number of stepfamilies is growing. Between 1980 and 1990, the number of stepfamilies increased 36 percent, according to the National Center for Health Statistics.

In addition, more families are being built by same-sex couples, through adoption, and by extended-family members living under the same roof and often working together in the same business. All these constituencies have an interest in valuation, and owners need to prepare for it.

Failure to plan may mean that family members who made recent and meaningful contributions to the business may not be recognized in terms of ownership or responsibility. It's not uncommon for successive spouses to resist sharing assets with the minor or adult children of a deceased spouse's previous marriage or marriages.



Same-sex couples need to do extensive planning for the safety and continuance of a family business. It's particularly important to select an estate attorney who can not only craft conventional wills and health power-of-attorney documents but also create designation-of-agent documents for issues such as hospital visitation rights, funeral arrangements, and possession of personal property.

Multigenerational planning should also address estate and child-custody arrangements for unmarried heterosexual or gay couples who may not have done the appropriate legal planning necessary to secure the estates of their current or past partners and heirs. At the very least, all family members should understand the need for such planning to prevent conflict later. As nontraditional families become more common, business owners need to be open to estate discussions that consider all these family members.

Creating contingency plans for relatives who renege

"Mom, I don't want the business" is a phrase that has been uttered in more than a few family-owned companies, sometimes years after the person who says it made that business his career. If a founder is lucky, she's alive to hear it and can rethink her succession, transfer, or sale plans.

But for any number of reasons, such decisions may be made after the business owner's funeral, when children, siblings, and in-laws finally settle into the reality that the responsibility for the future of the company is theirs and theirs alone. People can and do change their minds about whether they want a family legacy to continue. Business owners always need to have a Plan B for other owners and family members to put in place if next-generation leadership decides not to lead.

Valuation isn't just about bricks and mortar and the machinery on the shop floor; it's also about management talent and vision. People *do* matter in the valuation of a business. A prodigal son may finally be put in charge and realize that he really doesn't want the job. Smart owners need to consider that possibility in their estate plans if they want to ensure a financial future for other family members and employees.

In Chapter 24, we talk about employee stock ownership plans (ESOPs), which are among the options founders may build into their estate-planning strategies. Business founders create an ESOP as a way to pull assets out of a business while securing the business's future into the next generation.

Creating a Succession Plan

You often hear that a solid succession plan needs to go into effect three to five years before a founder leaves. But any time an estate plan is written or updated, it makes sense to think through — and put in writing, if possible — an updated succession plan.

In the best scenario for a small business, succession planning should be one of the most important activities under the business-planning umbrella. This planning should start as early as possible, but later-stage planning comes closer to the founder's retirement, when she has a better picture of the company's management and financial health and can decide whether the company should continue with the next generation or be sold.

Here are the key steps involved in creating a succession plan:

1. Spend some time thinking about family dynamics.

As an owner, you need to consider the family before you consider the business. At a certain point, it's important to consider whether personality conflicts at home can spill over into the work environment.

2. Bring in a valuation professional early.

Develop a baseline valuation for the business to get a preview of whether you can do anything to minimize the tax impact of transferring assets to your heirs.

3. Consider possible successors.

You have to decide which members of the family to put in charge. You need to know whether multiple members of the next generation can work together and what provisions you can make for those who don't want to be involved but deserve a slice of the family assets.

4. Train the possible successors.

You may want to start a formal training program for the relatives you want to put in positions of leadership. This program may involve giving these relatives apprenticeships in the company or possibly paying for them to get undergraduate or graduate training in business or a field specific to a strength needed inside the firm.

5. Make the choice.

This step is about making the tough final decision about which family member (or nonfamily member) will succeed you in your job and which contenders will take lesser roles.

6. Make the ownership transfer.

This step is where the legal and tax considerations come in. You may be able to blunt the tax impact by selling or gifting shares of the business to children during times when share values are low. (For more information on gifting, see the “Taking Gifting into Consideration” section, later in this chapter.)

Creating an Estate Plan

Estate planning is a combination of personal wealth planning and strategic planning for the business. It anticipates and answers questions such as the following:

- ✓ If the founder dies or becomes incapacitated, who will run the business, and under what circumstances?
- ✓ If no family member wants to run the business, how will it be disposed of?
- ✓ Are wills and choices of executor and trustees in place for personal assets?
- ✓ What plans are in place to gift or dispose of certain assets to family members to reduce the estate-tax hit?

Founders shouldn't address these issues in a vacuum. In addition to enlisting the help of experts (see the section titled “Finding the Experts You Need for Estate Planning,” later in this chapter), business founders need to talk with their spouses and other key members of the family who are employed in the business (such as children, siblings, cousins, nieces, and nephews) to get an idea of how they feel about the following issues:

- ✓ How to continue the business after the founder retires or dies
- ✓ Which family member should be elevated to replace the founder of the business after he leaves that post

- ✔ What kind of estate and succession plans would be good for the next generation
- ✔ Which designated events in the life of the founder or the business call for a valuation to take place
- ✔ How in-laws who are involved in the business should share in the assets
- ✔ How minor children should share in the assets
- ✔ How spouses and former spouses (depending on divorce agreements) should be treated at the time of the owner's death
- ✔ How to continue or change any philanthropic activities set in place by the owner



Founders have to realize that an estate plan isn't an attempt to control a company or a family from beyond the grave. When a powerful person dies, the death creates a vacuum that eventually has to be filled. With the right outlook, planning, and communication in building that estate plan, however, the founder communicates a vision for the firm that the next generation will want to embrace while adding their own ideas to improve what the founder created.

Finding the Experts You Need for Estate Planning

One key reason to bring in valuation professionals for business estate matters is to get a measure of potential tax consequences for those who will inherit the family business. Here are the experts that business owners should consider bringing in as a team to ensure proper estate planning as well as proper valuation:

- ✔ **Accountants/auditors:** These professionals help ensure that thorough, professionally prepared tax records exist over a period of years for the business. Income and spending need to be documented and verified. Annual tax data is critical for pointing out estate-planning issues that owners need to watch, and it sets the stage for accurate, in-depth valuation.
- ✔ **Valuation professionals:** As long as you ensure confidentiality, you should keep in touch with trusted, skilled appraisers and other valuation experts during the life of a business. They can keep you abreast of ways to maximize the value of your firm.
- ✔ **Estate attorneys:** Attorneys are the primary legal experts involved in creating a combined personal/business estate plan. They know the laws and procedures related to estate matters, and if they aren't also Certified Public Accountants (as some estate attorneys are), they work closely with CPAs who specialize in estate matters.

- ✔ **Financial planners/advisors:** A trained and certified financial planner can be the quarterback in a long-term estate-planning strategy.
- ✔ **Divorce/family-law attorneys:** Involving a divorce or family-law attorney is critical if the founder has children or other heirs from a previous marriage.

See Chapter 7 for tips on finding and hiring the correct professionals in the valuation process.

Fitting Buy/Sell Agreements into Estate Planning and Valuation

Creating a buy/sell agreement isn't estate planning per se, but it should be coordinated with an estate plan to make sure that transactional issues in a business coordinate with the intentions set forth in a partner or owner's estate plan.

A *buy/sell agreement* creates an infrastructure for setting the value of a business for estate-tax purposes and improves your estate's liquidity by ensuring a ready market for your business upon your death. Such an agreement also protects your business partners from having to share ownership with a deceased stockholder's family.

Buy/sell agreements come in two flavors:

- ✔ **Cross-purchase:** In an insurance-funded cross-purchase arrangement, each business owner buys an insurance policy on the other, naming the other as the beneficiary. At the death of one of the owners, the surviving owner receives tax-free insurance proceeds to use to purchase the deceased owner's stock from her estate.
- ✔ **Stock-redemption:** In an insurance-funded stock-redemption arrangement, the corporation purchases the stock of a deceased shareholder. In this situation, the business is the owner and beneficiary of life insurance policies on each shareholder. A partnership looking for a business continuation plan may use a similar arrangement, called an *entity purchase*.

You can find more information on buy/sell agreements in Chapter 23.

Taking Gifting into Consideration

As business assets are passed down from one generation to the next, the tax hit can be huge. For this reason, some estate planners urge you to consider various gifting strategies as part of a comprehensive estate plan.

Gifting is exactly what it sounds like: You make a gift of your assets to friends and relatives over the course of time to bring down the level of your assets so that your heirs won't be clobbered as badly by estate taxes when you die.



Gifting shouldn't be an automatic decision. It requires the help of a trained tax advisor.

Gifting strategies

People can choose from a variety of options to give away money and assets in a way that will serve the company and family:

- ✓ **Using life insurance trusts:** An irrevocable life insurance trust can keep the proceeds of the insurance out of your taxable estate. An added benefit is that such trusts may permit spousal access to the cash value of the policy. Note, however, that the trust is irrevocable — the decision can't be changed.
- ✓ **Planning for increasing assets:** A grantor-retained annuity trust (GRAT) is an irrevocable trust that's popular among families with assets that are expected to increase, because such appreciation can be passed on to heirs with minimal tax consequences.
- ✓ **Gifting to grandkids:** The federal generation-skipping transfer tax (GSTT) taxes transfers of property that you make, either during life or after death, to someone who is more than one generation below you, such as a grandchild. The GSTT is imposed in addition to — not rather than — federal gift or estate taxes. You need to be aware of the GSTT if you make cumulative generation-skipping transfers in excess of the GSTT exemption, which was \$2 million in 2008. A flat tax equal to the highest estate-tax bracket in effect in the year in which you make the transfer is imposed on every transfer you make after your exemption has been exhausted. Note that some states also impose their own GSTT.

Successful business owners need to think about a lifetime gifting strategy. The generation-skipping transfer tax is one approach to this idea, but depending on what happens with the estate-tax forecast in 2009 and beyond, a low-rate environment may make it a good idea to take full advantage of these strategies.

Giftng techniques

You should consider — and in appropriate situations, implement — gifting techniques that leverage the lifetime exemption. We discuss some of these techniques in the following sections.

Intrafamily loans

With an *intrafamily loan*, the business owner can lend money to the transferee (a person, trust, or business entity), with the loan being documented by a promissory note bearing interest at the applicable federal rate (AFR). The borrower can use this loan to pay down higher-rate debt or make investments that are expected to achieve a rate of return higher than the AFR. Any returns in excess of the AFR are retained by the borrower free of gift or estate tax.

GRATs

In a *grantor-retained annuity trust* (GRAT), the business owner transfers assets to a trust for a certain period. During the term of the trust, the grantor receives an annuity payment, at least annually, of either a fixed dollar amount or a fixed percentage of the fair-market value of the property placed in the trust. The interest rate used to calculate the annuity payment is the applicable federal rate (AFR). At the end of the trust term, any remaining principal is distributed to the trust beneficiaries.

Installment sales to IDGTs

Intentionally defective grantor trusts (IDGTs) are similar to GRATs. IDGT assets are sold by the owner to a trust in return for an installment note that bears interest at the AFR. The note may provide for installment payments over a specified period, or it may provide for annual interest-only payments with a balloon payment of principal payable at the end of the term. Any income and appreciation on the trust assets exceeding the payments required to satisfy the note belong to the trust beneficiaries free of estate or gift tax at the end of the trust term. The owner pays no tax on his gain from the sale of assets to the trust and is responsible for paying income tax on the future income earned by the trust — a benefit to the trust beneficiaries that is not treated as an additional gift by the grantor.



How the estate tax was born

According to the Washington, D.C.–based Heritage Foundation, the tradition of taxing assets at the time of death began with the Stamp Act of 1797, which required a federal stamp on wills in probate. The revenue was used to pay off debt during the undeclared naval war with France in 1794. The Stamp Act was repealed in 1802.

For the next hundred years, estate taxes were used on a sporadic basis to finance wars, and when peacetime came, such taxes were repealed. But after the turn of the 20th century, the modern sales tax emerged, along with another tax we note with fondness: federal income tax.

The Revenue Act of 1916 contained an estate tax with many features of today's system. After an exemption of \$50,000 — equal today to roughly \$11 million — tax rates started at 1 percent and climbed to 10 percent on estates of more than \$5 million (more than \$1 billion in terms of today's wealth).

Estate taxes were increased in 1917 as the United States entered World War I. This time, when the war ended, the tax stayed. Even though the country had a budget surplus, Congress increased rates and introduced a gift tax in 1924. Like the estate tax, the *gift tax* is a levy on the transfer of property from one person to another.

From the 1920s through the 1940s — the Depression years — estate taxes were used as a way to redistribute income. Tax rates of up to 77 percent on the largest estates were supposed to prevent wealth from becoming increasingly concentrated in the hands of a few.

Lawmakers went back to work on the estate tax during the 1960s and 1970s. By 1976, the previously separate exemptions for estate and gift taxes were transformed into a single unified estate and gift tax credit.

By 1981, the top rate went from 70 percent to 50 percent, and an increase in the unified credit took a lot of smaller estates — those under \$600,000 — off the tax rolls.

In 1997, Congress made the first increase in the unified credit since 1987. Gradual increases, which began in 1999, raised the unified credit to \$1 million by 2006.

The Economic Growth and Tax Relief Reconciliation Act of 2001 was the first step toward eliminating the death tax. It provided for a scheduled phase-out of rates and an increase in the unified credit, finally repealing the tax for calendar year 2010. Those provisions sunset in 2011 with a return to the 1997 levels of a top rate of 55 percent and a unified credit of \$1 million.



Under current law, the federal estate tax is scheduled to change as follows:

- ✓ **2009:** \$3.5 million exemption, 45 percent tax rate
- ✓ **2010:** No estate tax
- ✓ **2011 and beyond:** \$1 million exemption, 55 percent tax rate

CLATs

A *charitable lead annuity trust* (CLAT) provides for the payment of a fixed dollar amount to one or more charitable beneficiaries for a specified period, at least annually, regardless of the income generated by the CLAT. At the end of the term, the remaining assets of the trust pass to individual beneficiaries. The trust may be established for a term of years or based on the lives of the people living at the time of the trust's creation. Gift leverage is obtained because the reportable value of the gift at the creation of the CLAT is the fair-market value of the assets placed in the trust less the present value of the annuity.

Chapter 21

Attracting Outside Investors to Your Startup

In This Chapter

- ▶ Finding out what you need to do before a startup
 - ▶ Filling out a valuation worksheet for investors
 - ▶ Understanding the roles of valuation professionals in a startup
 - ▶ Working with different types of investors
-

Every owner of a young company needs good advice to prepare him for the many stages of investment that will eventually take his business to the desired size as a private company or all the way to public ownership.

Particularly in the technology arena, many business owners work hard to solicit financing to help their companies grow at very fast rates. But because proving value in new companies that may not yet be producing much in revenue and profit is difficult, you need outside expertise.

In many ways, the process of attracting outside investors is not much different from the process of bringing in a conventional buyer or banker. Even if you started your company in a garage or a basement, you have to present it as an organized company, with transparent operations and finances, to any potential buyers, investors, or lenders; otherwise, they just won't care.

This chapter outlines the importance of getting valuation expertise when starting a business and the areas in which you should use outside help.

Exploring Your Startup Resources

We emphasize throughout this book that no two valuation professionals analyze the value of a business in exactly the same way. When you're talking about a startup, you're talking about a particular valuation challenge because startups may not produce revenues, much less profits, for months and possibly years.

For this reason, you should network with experienced investors in startup companies similar to yours to get an idea of what they look for in fledgling companies. If some of these investors are successful at sniffing out values in new business ideas, you should find these people, listen to their advice, and then start building your company to produce the most value you can.

You can take several steps before you start chasing investors. The Ewing Marion Kauffman Foundation's Angel Capital Education Foundation (www.kauffman.org) publishes a host of startup resources. One of these resources is the Valuation Worksheet, which follows. It serves as a general guide to the startup valuation process.

The worksheet asks you to evaluate three aspects of a company — the strength of the management team, the size of the opportunity, and the competitive landscape — and it lists percentages to help you assign a weight to each question. The questions represent the factors and issues impacting the valuation of a pre-revenue startup company (a company that hasn't yet begun to bring in revenue).

Valuation Worksheet

Strength of Management Team (Weighted Ranking: 0–30%)

Impact

--

-

+

+

++

++

+++

What is the founder's experience?

Straight out of school

Experience only as a salesperson or technologist

Many years business experience

Experience as a product manager

Experience in this business sector

Experience as a COO, CTO, CFO

Experience as a CEO

<i>Impact</i>	<i>Is the founder willing to step aside, if necessary, for a new CEO?</i>
Deal killer	Unwilling
–	Difficult to convince
0	Neutral
+	Willing
++	Key part of the plan
<i>Impact</i>	<i>Is the founder coachable?</i>
Deal killer	No
0	Yes
<i>Impact</i>	<i>How complete is the management team?</i>
--	Very incomplete (none identified)
–	Somewhat incomplete
0	Good start
+	Rather complete team
++	A complete and experienced management team
Size of the Opportunity (Weighted Ranking: 0–25%)	
<i>Impact</i>	<i>What size is the specific market for the company's product/service?</i>
Deal killer	< \$50,000,000
0	\$100,000,000
++	> \$500,000,000
<i>Impact</i>	<i>What is the potential for revenue in five years?</i>
Deal killer	< \$30,000,000
0	\$50,000,000
++	> \$100,000,000
Competitive Landscape (Weighted Ranking: 0–15%)	
<i>Impact</i>	<i>What is the status of the intellectual property (IP)?</i>
0	Trade secrets only
+	Core patents pending
++	Core patents issued
+++	Complete patent estate

Source: Ewing Marion Kauffman Foundation

Seeing How Valuation Professionals Work with Startups

When a valuation professional gets involved in valuing a startup, the analysis centers on a discounted cash-flow methodology under the income approach to valuation. (For a review of all the professionals who may get involved in the valuation process, see Chapter 7.)

In essence, the valuation professional is trying to determine a future valuation of the company so that the entrepreneurs, angel investors, venture capitalists, and so on have some idea how much equity they should have in the startup, given their investment and the corresponding return on investment (ROI). (For definitions of investor types, see the section “Working with Investors,” later in this chapter.)

Valuation terms you hear in a startup

The world of startup investing has its own valuation language. Here are some of the terms you may hear:

- ✔ **Pre-revenue startup:** A business that's burning through cash in its accounts because it hasn't yet begun to bring in revenue for the product that it plans to sell; it may have an office in place and a prototype but nothing that's bringing in cash; some investors see this type of company as a problem, whereas others see it as an opportunity
- ✔ **Pre-money value:** A company's value before it receives outside financing or the latest round of financing
- ✔ **Post-money value:** A company's value after outside financing or the latest round or injection of equity funding
- ✔ **Divergence:** The difference between the growth rate of the company's valuation and the valuation of the shares investors receive because of dilution by subsequent investors and other factors
- ✔ **Full dilution:** This counts not only the shares that have been issued but also all shares that would be issued if all options and warrants were exercised and other promises or contingent agreements to issue shares were given effect
- ✔ **Terminal value:** The valuation of the company at exit — that is, the proceeds of the sale of the company via a merger, acquisition, or an IPO, at which time the investors' ownership can be liquidated
- ✔ **ROI:** The return expected for such an investment when the investors expect to get their money out

The process is very similar to the discounted cash-flow technique used to value a mature business. The major difference lies in the discount and capitalization rates. A company that isn't producing substantial revenue and/or profit, that lacks the necessary infrastructure to take the company to the next level, and that doesn't have the next generation of technology in development is inherently more risky for angel investors or venture capitalists. After all, if it weren't more risky, the entrepreneur could simply go to a bank for financing.

Creating the Starting Point: The Business Plan

This book is about business valuation, not starting a business. For information on that topic, you can check out *Small Business For Dummies*, 3rd Edition, by Eric Tyson, MBA, and Jim Schell (Wiley); *Accounting For Dummies*, 4th Edition, by John A. Tracy, CPA (Wiley); or *Franchising For Dummies*, 2nd Edition, by Michael Seid and Dave Thomas (Wiley). Even so, an appreciation for business valuation starts with a business plan.

If you want people to invest in your business, or if you need bank loans, you need a business plan. Consider a business plan to be a calling card for your new business, and keep the emphasis on the issue of value at every stage.

The standard business plan runs anywhere from 10 to 30 pages and contains the following elements:

- ✓ **Executive summary:** An executive summary should be no longer than one page. It sums up the business, its products and services, and its risks, opportunities, target strategies, competition, finances, and projected ROI.

The summary includes the first words anyone will read, but write it *after* you create the rest of the document. Doing so ensures that you're clear on the full thrust of the document so you can better summarize it in front.

- ✓ **Mission statement:** This one- or two-sentence statement describes the culture of your business and its goals.
- ✓ **Business concept:** Here, you explain the business that you want to finance and the technology, concept, or strategy on which it's based.



- ✔ **Management team:** List the chief executive officer (CEO) and key members of management by name, experience, and — very importantly — past successes.
- ✔ **Industry analysis:** This section provides an informed overview of market share, leadership, players in the market, market shifts, costs, pricing, or competition that provides the opportunity for the new company's success.
- ✔ **Competition:** In this section, you outline the competitive challenges you face and how you plan to defeat them.
- ✔ **Goals and objectives:** This section — essentially, a three- to five-year plan — requires you to outline measurable objectives for market share, revenue, profitability, and value.
- ✔ **Day-to-day operations:** Here, you describe staffing plans, training, and other personnel-related issues. This section also talks about business-support activities, such as advertising and marketing.
- ✔ **Financing:** This detailed section explains what you have to invest and what you need from lenders. Most importantly, it explains how long you expect to take to pay back those lenders.
- ✔ **Appendix:** This section contains tax returns and any other third-party information that tells prospective investors more about the business.



You're not writing a business plan for insiders; you're writing it for outsiders. You're writing it to sell the concept of the company to people who are willing to sink money into it — lenders, investors, customers, and suppliers. They're your audience, and you have to sell your value proposition to them.

Working with Investors

Valuation is a contentious subject in any business transaction, but startups are particularly controversial because assets are either undeveloped or nonexistent. Some companies are in operation for a year or more and never bring in a dime of revenue because they're too engaged in product development and early work to build clientele.

The search for money to fuel a new operation can be almost as big of a job as getting the company operating on a day-to-day basis. Therefore, in the art-versus-science discussion of valuation, the startup world presents some rather massive challenges.

In this section, we discuss the three primary types of investors who typically deal with startup and young companies:

- ✓ Angel investors
- ✓ Venture capitalists
- ✓ Investors in an initial public offering (IPO)

How do you find these sources of capital? If you're truly familiar with the industry in which you're planning to start a business, you'll have done your homework trying to determine how companies like yours are best funded. If not, you need to focus on research. Here are some primary ways to find out where to start researching such investors:

- ✓ **Industry associations:** These organizations bring together people working in the same industry. Read their publications, visit their Web sites, and talk with their members not only to find out more about the industry you plan to work in but also to discover about how other business owners financed their startups.
- ✓ **Angel investor directories:** These directories provide you with names of angel investors all over the country. *Inc.* magazine publishes an online directory (www.inc.com/articles/2001/09/23461.html) through which you can find out the kind of companies these investors are interested in supporting. We talk more about angel investors in the next section.
- ✓ **Local business groups:** Industry associations are typically national groups, but if you live in an area that contains a number of businesses in your chosen industry, you may be able to use local business groups as a way to find the right kind of investor for you.



Pre-money valuation refers to the valuation of a company prior to investment or other form of financing. Angel investors and venture capitalists use pre-money valuation to determine how much ownership or equity they'll demand from the company in exchange for their investments.

Angel investors

An *angel investor* provides capital to one or more startup companies. Usually, she's a wealthy person who likes to dabble in young businesses with great potential.

Most new businesses tap friends and family members for early seed money. This early money — and your handling of it — can make your business more attractive to angel investors if you have a hot idea and the talent to bring it forward. *Angels*, as they're often called, tend to be the first rung of outside financing for companies that hope to go to the next stage: expanding product distribution, starting advertising and promotion campaigns, or expanding staff.

Sometimes, you can find angels by word of mouth in your industry. Some angels pool their resources with other angels and make their funding decisions in a group. Like venture capitalists (see the following section), who are much bigger fish, angels like to see not only good road shows but also solid presentations and figures by the eager entrepreneurs they meet.

Angels focus on the youngest companies because these investors usually aren't in the game for big money; they come in with thousands of dollars, not millions. Most individual angels invest no more than \$100,000 (most often, less than \$30,000). According to the Ewing Marion Kauffman Foundation, the typical combined angel contribution is around \$1 million to \$3 million.

On average, angels buy 20 to 40 percent of a company's equity and seek a return of 20 to 30 times their investment over five years.



The best angels don't just hand over a check; they're also good sounding boards and teachers. Make sure you pick a good angel investor who has much to teach you about building a company.

Venture capitalists

A *venture capitalist* (VC) is similar to an angel investor in that he (or a firm created to make venture capital investments) wants to put his money in promising companies for big returns. Generally, a VC comes after angel financing and may be the final stage of private investment. The minimum investment by VCs is \$1 million, and these investors are more hands-on than angel investors in their relationships with new firms. VCs typically want a formal advisory role with new companies, usually as board members.

Getting VC financing brings you one step closer to the big leagues: public ownership. These investors finance companies that haven't had the value of their stock tested in the public markets.

Vcs look at companies that have made it through the self-investment or angel stage with considerable promise but many unknowns. These companies may have a great business concept, but they also may have untested management, unknown customer response, and other aspects that make valuation tougher — not the least of which is lack of profit.



As you create your business plan (refer to the “Creating the Starting Point: The Business Plan” section earlier in this chapter), your job is to work with experts in finance to value your potential business and markets properly. Venture capitalists want to know that you’re paying proper attention to valuing your company reliably. After all, to invest in your company, they need to understand its value, and most importantly, they need to know that you understand its value.

IPO investors

For entrepreneurs, angel investors, venture capitalists, and ordinary investors, an *initial public offering* (IPO) is a fancier phrase for something that tantalizes everyone: a big payday. The IPO is the first sale of stock to the public. You’ve probably read business stories that contain phrases such as “highly anticipated IPO.”



Google was one such IPO that had investors licking their lips in 2004, even at a relatively high offering price of \$85 a share. Was the Google IPO worthwhile? Despite a market turndown, during the writing of this book, Google stock was trading above \$300 a share.

Business valuation continues into the pricing process for companies that go into the public markets after early angel financing and one or more rounds of VC financing.

Traditional valuation procedures don’t always work for an IPO, because virtually all valuation is based on the future of the business — not on the present. You can’t value an IPO based on its book or liquidation value, except for the purpose of establishing a floor price for the business.

Obviously, if you’re talking about a startup, it’s going to be a while before you’re ready for that IPO. Still, an IPO may well be in your future. At each stage of investment, you need experts who understand valuation at that stage.

