RISR

Business Valuation Guide

A summary of how RISR implements best practice methods to estimate your client's business value.

The power of data

Encouraging your clients to share high quality data is the single best way to ensure the reasonableness of the generated valuation estimates.

That's why RISR makes it easy for clients to share data by linking their QuickBooks Online accounts or upload tax documents.

Questions about our valuation method?

support@risr.com

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We are here to help

You should feel confident in the insights you provide your client.

Send questions about our valuation methods to **support@risr.com.**

Overview of Models

Equity Value (not Enterprise Value)

The estimated range of value on the RISR platform reflects the ***Equity Value*** of the business. This is a nuanced difference from ***Enterprise Value*** and is intentional.

Equity Value reflects the business value after paying off all outstanding debt. In layman's terms, the equity value reflects a reasonable value that the equity owners of the business could expect to receive in the event of a sale.

Enterprise Value reflects the total market capitalization of the business. It includes the value available for both debt and equity holders.

By adjusting valuation estimates for interest-bearing debt and net working capital, RISR estimates the Equity Value for each client business.

Determining the Estimated Range of Equity Value

For each client business, RISR estimates a range of equity value.

How the model works:

1. Estimate the Equity Value three ways using a combination of Income and Market Approaches
2. Detect and remove any outliers within the three estimates
3. Establish a range based on the low and high end of the estimates

Aggregating three widely-used, best practice valuation models increases the likelihood that valuation ranges shown are reasonable estimates given the business's characteristics.

Estimating Current Valuation

RISR leverages three common methods for estimating a range of values for small-to-mid sized private businesses.

Method 1. Income Approach: *Capitalization of Earnings*

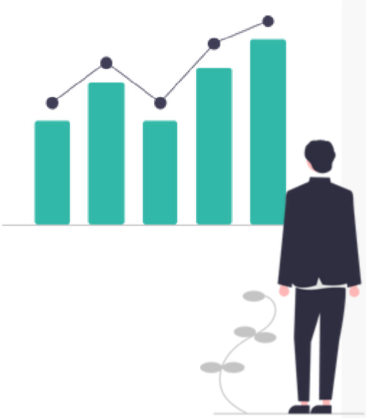
The Income Approach applies a capitalization rate to projected future streams of cash flow from a business on the assumption that there is a relationship between the amount of income that a business will earn and its fair market value.

This may be done through several techniques including the Capitalization of Earnings Method or a Discounted Cash Flow Method.

RISR uses the Capitalization of Earnings Method to estimate the value of the business.

This method assumes the future estimated earnings of the business is reflective of historic results. Historical earnings before interest, taxes, depreciation and amortization are adjusted to reduce unusual or excessive operating expenses and then divided by a capitalization rate calculated using a weighted average cost of capital.

Additional detail on how this model is implemented in RISR is shown on Page 5.



Why not Discounted Cash Flow (DCF) Method?

The Discounted Cash Flow (DCF) Model is a commonly used approach for valuing businesses based on future earnings potential and requires business owners to provide long term financial forecasts for the company. Currently this method is not implemented in the RISR platform.

Though RISR may implement the DCF Model in the future, SMBs are notoriously hard to project earnings for, so the DCF model is typically reserved for larger businesses with robust pro formas.

Method 2. Market Approach: *Guideline Transaction Method with EBITDA Multiple*

The Market Approach uses past transaction data from comparable companies to estimate the business value. RISR utilizes the Guideline Transaction Method to calculate value under the Market Approach.

The Guideline Transaction Method uses information from sales of controlling interests in privately held businesses and compares the applicable ratio to the financial metrics of the target company.

Selecting appropriate multiples is critical to estimating reasonable valuations under Market Approaches. RISR references a database of over 140,000 transactions across 800 industries to find comparable multiples to use for each client based on their industry and size.

Typically, larger companies command higher multiples compared to smaller companies in the same industry. This is called the size effect, and accounts for the stability that comes with larger companies.

To implement the Guideline Transaction Method, RISR selects multiples for Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) using the client's industry and size.

This multiple is then applied to the client company's financials to generate an estimate of company value.

Additional detail on how this model is implemented in RISR is shown on Page 7.

Method 3. Market Approach: *Guideline Transaction Method with Revenue Multiple*

Similar to the Guideline Transaction Method with EBITDA Multiple above, RISR also selects valuation multiples to be applied to the Revenue of the client's business to estimate valuation. In this model, RISR uses the client's industry and size to select valuation multiples to be applied to their Revenue.

Additional detail on how this model is implemented in RISR is shown on Page 7.

Estimating Dream Valuation

Helping owners understand the practical implications of the value of their business is one of the best ways to build trust and help them prepare for the future.

To help with this, RISR estimates a Dream Valuation for each client business.

Dream Valuations estimate what the business needs to be worth for the client to achieve their goals after they transition or exit from the business.

How it works:

1. Identify the amount of cash the client needs to achieve their goals after exit using a present value calculation
2. Determine what the value of the business needs to be to reach that cash requirement given the client's ownership percentage and average tax rates

Detailed Review of Methods

Capitalization of Earnings Method

RISR uses the Capitalization of Earnings Model to identify the present value of estimated future earnings for each client.

How RISR implements this model:

1. Estimate future earnings, represented as Projected Sustainable EBITDA
2. Determine a Capitalization Rate
3. Adjusting for interest-bearing debt and net working capital

Estimating future earnings

RISR represents estimates of future earnings as Projected Sustainable EBITDA within the platform and in generated reports. This value reflects the net cash flow that invested capital is expected to generate in the event of a transition or sale.

How Projected Sustainable EBITDA is calculated:

1. Take the weighted average of historic EBITDA values

RISR first reviews the previous one to three years of a client's Profit & Loss financial data to assess the EBITDA the company has been generating. This is done by adding Depreciation, Amortization, Interest Expense, and an estimate of Tax Expenses to reported Net Income.

Then, a weighted average of historical EBITDA values is taken, placing greater weight on recent years.

2. Normalize the weighted average for discretionary expenses or "add-backs"

The weighted average is then normalized to account for any expenses that otherwise wouldn't occur under different management (i.e. Profit Sharing Expenses and Other Discretionary Expenses). Read more on how RISR normalizes EBITDA on Page 9.

Once calculated, the Projected Sustainable EBITDA is used in perpetuity to estimate the valuation of the company.

Determining Capitalization Rate

Once Projected Sustainable EBITDA is estimated, a Capitalization Rate must be applied to identify the present value of future earnings.

Capitalization Rate reflects:

1. The specific risk associated with the business

To determine the specific company risk, RISR asks clients questions to better understand how stable and consistent their revenue, operating mechanics, and financial maturity are.

Read more on how company risk impacts valuation on Page 10.

2. The required rate of return a hypothetical investor would expect

Required rate of return is based on the cost of capital and the expected long-term sustainable growth rate of the company. RISR maintains up-to-date economic and market data to estimate the cost of debt and equity and applies a conservative long-term sustainable growth rate for each business.

Businesses with lower specific company risk typically achieve lower capitalization rates, yielding a higher valuation.

Estimating Equity Value

With Projected Sustainable EBITDA and Capitalization Rate estimated, RISR can estimate the valuation of the client’s business.

To do this, Projected Sustainable EBITDA is divided by the Capitalization Rate to determine the present value of future earnings.

Once complete, final adjustments are made to account for any interest bearing debt or surpluses in net working capital the business may have to isolate the value of the company’s equity.

EBITDA and Revenue Multiple Methods

The Market Approach models using EBITDA and Revenue estimates business value by comparing the client's company to similar businesses that have been sold. This approach leverages market data to gauge what buyers are willing to pay for businesses with similar characteristics.

To do this, the average ratio between the sale value and key company financials like EBITDA and Revenue are calculated. These ratios, or "multiples", are then applied to the client's financials with adjustments to account for differences between the companies to estimate valuation.

How RISR implements these models:

1. Select a multiple using comparable transactions
2. Apply each multiple to Projected Sustainable EBITDA and Revenue accordingly
3. Adjust for debt, net working capital, and company risk

Selecting multiples using comparable transactions

RISR maintains a database of up-to-date precedent private company transactions from the past 10 years with data for over 800 industries. RISR uses the client's industry, EBITDA, and Revenue to select multiples that are appropriate for the company's industry and size.

Companies with larger EBITDAs and Revenues tend to earn higher multiples since they are seen as more stable to prospective investors. This *size effect* is important because growing EBITDA can yield a non-linear increase in valuation if the next multiple up is achieved by the business.

For each client RISR uses an EBITDA market multiple to estimate valuation. When available, a Revenue market multiple is also used as a reference estimate for valuation.

You can request the range of multiples applied to your client's valuation any time by emailing **support@risr.com**.

Apply multiples to Projected Sustainable EBITDA and Revenue

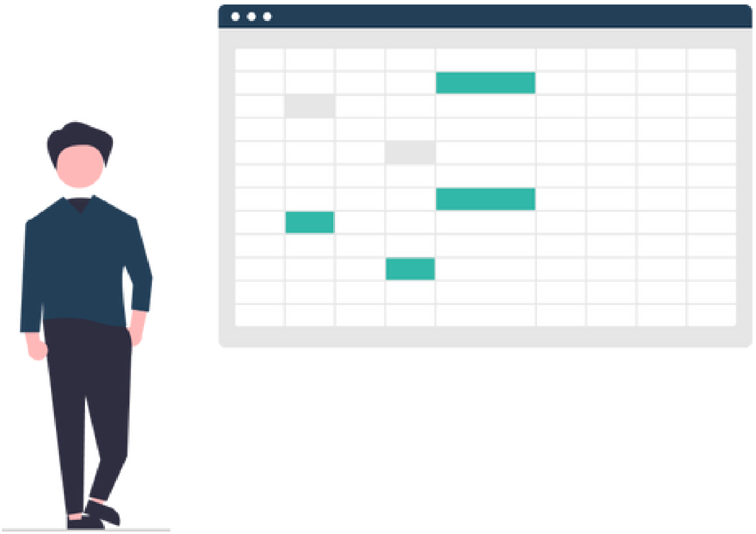
Once a reference multiple is selected for each financial metric it is applied to Projected Sustainable EBITDA and the previous year's revenue accordingly.

Adjustment for debt, net working capital, and company risk

Since no two businesses are identical, adjustments are made to account for differences in marketability and company risk between the client's business and the market data

Similar to the Capitalization Rate calculation in the Capitalization of Earnings model, RISR adjusts the Market Approach estimate based on the marketability and risk factors of the client's business.

Read more on how company risk impacts valuation on Page 9.



Key Factors to Consider

The importance of normalizing EBITDA

Normalizing earnings, or accounting for “add-backs”, when estimating company valuation is a nuanced and important step to getting a reasonable estimate of a company’s value.

This step is particularly important for small-to-medium businesses since normalizing EBITDA can cause large changes in estimated value for small businesses.

Earnings need to be normalized because owners of small businesses typically run discretionary expenses through their business to optimize for lowering their taxes; not for increasing the value of their business.

As a result, the Profit & Loss statement for a small business may include meaningful expenses that would not occur under different management. To properly reflect the company’s ability to generate earnings, these expenses are added back to the estimate of future earnings.

Within the RISR platform Profit Sharing Expenses and Other Discretionary Expenses are data inputs that are added back to earnings to calculate the Projected Sustainable EBITDA.

Ensuring that the data provided for these items are reasonable whenever possible is a good practice for ensuring the reasonableness of valuation estimates.

The importance of company risk

To properly estimate valuation, the specific risk profile of each business must be accounted for. Risk varies based on the company's operating practices, stability of revenue streams, and concentrations of reliance on customers, vendors, and talent.

Using survey-style questions and analysis of financial metrics, RISR estimates risk for the following categories for each company:

- **Customer concentration.** The level of reliance revenue is on a small number of customers
- **Quality of earnings.** The likelihood that revenue will repeat and remain consistent.
- **Vendor concentration.** The level of reliance on a small number of vendors to serve customers
- **Owner dependency.** The business's reliance on the owner to sustainably operate and grow
- **Key employee dependency.** The business's reliance on the key employees to sustainably operate and grow.
- **Financial operating practices.** The maturity of the business's financial practices based on who typically maintains their record keeping.

Based on client responses to these questions, premiums or discounts are applied to each model to account for the risk of the company.

Glossary of Terms

Variable	Description	How it's used
Accounts Payable	The total reported amount the company owes to its suppliers or vendors for goods or services purchased on credit	Informs net working capital estimatesInforms liquidity insights
Accounts Receivable	The reported amounts of money owed to a company by its customers or clients for goods or services provided for the year	Informs net working capital estimatesInforms liquidity insights
Age at Retirement	The age the client expects to retire by	Informs Dream Valuation
Amortization	Total reported amortization of intangible assets for the year	Informs EBITDA estimates
Annual Income Requirement	The amount of cash the client needs each year after exit that is not already funded	Informs Dream Valuation
Cash and Cash Equivalents	The reported amount of cash the business has on hand based on their bank accounts for the year	Informs net working capital estimatesInforms liquidity insights
Cash Required to fund financial goals	An optional input for clients to identify what their cash requirement to achieve goals is if they know it already	Informs Dream Valuation estimate
Cost of Goods Sold / Cost of Sales	Total reported expenses incurred in the production of goods or services sold by the company for the year	Informs growth and cost management insights
Credit Cards & Short-term Debt	Credit cards, mortgages, notes, bonds, and other forms of debt due within 1 year	Informs net working capital estimatesInforms liquidity insights

Variable	Description	How it’s used
Current Retirement Savings	The amount of cash the client has set aside for life after transition	Informs Dream Valuation estimate
Depreciation	Total reported depreciation of tangible assets for the year	Informs EBITDA estimates
Financial Record Keeper	The person(s) responsible for maintaining financial practices at the company	Used to gauge the maturity of financial practices of the business and preparedness for
Fixed & Land Assets	The reported cost basis of fixed assets including land	Informs liquidity insights
Industry	The 6 digit NAICS code the client selects as most representative of their business	Informs Market Approach valuation models
Interest Expense	Total reported expenses paid on interest-bearing debt and financing	Informs EBITDA estimates
Key Employee Risk	The likelihood the business’s revenue and/or profitability will decline in the event of key employee departure	Informs key employee dependency risk
Legal Entity Structure	The tax structure the business falls under	Informs estimated tax expenses
Net Income	Total net earnings reported for the year	Informs EBITDA estimates
Non-Operating Expenses	Total reported costs for expenses not related to operating	Informs growth and cost management insights
Number of Customers	The count of customers the business has	Informs customer concentration risk
Operating Expenses	Total reported costs for operations for the year	Informs growth and cost management insights
Other Current Assets	Total reported assets on hand not accounted for by other variables that can be converted to cash or used within one year	Informs net working capital estimatesInforms liquidity insights

Variable	Description	How it's used
Other Current Liabilities	Total reported liabilities not accounted for by other variables that are due within one year	Informs net working capital estimates and interest-bearing debt estimatesInforms liquidity insights
Other Discretionary Expenses	Any other owner's expenses that otherwise wouldn't occur under different management (i.e. charitable contributions etc.)	Normalizes EBITDA estimates
Other Long-term Assets	Total reported assets on hand not accounted for by other variables that cannot be converted to cash or used within one year	Informs liquidity insights
Other Long-Term Debt	Total reported liabilities not captured by other variables that are due beyond the net one year	Informs interest-bearing debt estimatesInforms liquidity insights
Owner Risk	The likelihood the business's revenue and/or profitability will decline in the event of owner departure	Informs owner dependency risk
Owner's Compensation	The reported amount the owner is paid each year	Informs insights surrounding owner's compensation
Ownership Percentage	The percent of ownership the client has in his/her business	Informs Dream Valuation and Annual Income after Exit estimates
Profit Sharing Expenses	Total reported 401(k) contributions, profit sharing, or retirement payments to the owner	Normalizes EBITDA estimates
Projected 1 Year Revenue Growth	The revenue growth the client expects to achieve in the coming year	Informs time to Dream Valuation insights
Recurring, Renewing, and One-time Revenue Ratios	The quality of revenue streams based on likelihood to repeat.Recurring: Revenue that is contractually bound to repeat.Renewing: Revenue that is not contractually bound to repeat but is likely to repeatOne-time: Revenue that is not likely to repeat.	Informs revenue stability assessment
Retirement Legacy Requirement - Education	The amount of funds the client would like to dedicate to lineage education after transitioning from the business	Informs Dream Valuation

Variable	Description	How it’s used
Retirement Legacy Requirement - Other	The amount of funds the client would like to dedicate to other legacy goals after transitioning from the business	Informs Dream Valuation
Retirement Legacy Requirement - Philanthropy	The amount of funds the client would like to dedicate to philanthropic or charitable endeavors after transitioning from the business	Informs Dream Valuation
Retirement Legacy Requirement - Weddings	The amount of funds the client would like to dedicate to weddings after transitioning from the business	Informs Dream Valuation
Revenue	Total sales reported for the year	Informs Revenue Multiple valuation estimatesSurfaces insights on historic revenue growth
Revenue Concentration	The percent of revenue that relies on the client’s top two customers	Informs customer concentration risk
Vendor Concentration Risk	The percent of revenue that is reliant on one vendor	Informs supplier diversity risk