Excess Value:
Handling Assets Above and Beyond the Earnings Stream

Every business requires assets to generate income, but some companies have more assets than they need. Should these additional assets be included in the value of the company? As every valuation expert will tell you, "It depends."

The concept in question, known as "excess value," is a rich source of discussion among business analysts. Some aspects of excess value are very clear, while others require a fair amount of professional judgment.

Operating v. Non-Operating Assets

In a typical business valuation using the earnings approach, the estimated value is based on capitalization of earnings at a certain multiple. But what about the assets in the business? Should their value be added to the value of the company derived from an earnings approach? Generally, the answer is no because the operating assets of the company — working capital, property, plant and equipment — are required to generate the earnings upon which the valuation is based.

However, the company may have an array of other assets on the balance sheet that are of potential value. For example, the company may own such diverse assets as the cash surrender value of life insurance, marketable securities, investment land, antique cars or a vacation house. If these assets aren't required to generate earnings, they are considered non-operating assets and they *are* added to the value of the company derived from an earnings approach.

Note that when adjusting for non-operating assets, it is important to consider their impact on both the balance sheet and income statement. Related expenses and income related to the assets must be considered as part of the big picture.

What Is Excess?

To help valuation analysts assess where a business stands relative to its peers, most valuations include benchmarking research using industry-specific data or data from publicly traded comparable companies. Benchmarking brings to light the differences between the subject company and industry standards, and that's where the concept of "excess assets" often comes into play.

Suppose that benchmarking analysis shows that the current ratio (current assets less current liabilities) for the industry is 1.5 times more assets than liabilities, but the current ratio for the subject company is 2.5 times more assets than liabilities. This may mean that the company has excess assets. Maybe the company has more inventory than the industry norm. Or perhaps it has more cash, or pays its bills faster than its industry peers. In these cases, the company has assets in excess of the industry, and the value of the company would be adjusted accordingly.

In most cases, "excess" implies a positive, but sometimes an "excess" can point to a deficiency. For example, if the business is collecting receivables slower than the industry norm, those receivables might be reflected as excess assets, when in reality, the company may have problems with its customer base.

Excess value is sometimes difficult to identify and adjust for, but it is just one more variable on which valuation experts thrive.

Please contact our office if you would like to learn more about excess value relative to your business.

Personal Preferences Rule Small Businesses

Small businesses often have a fair amount of excess value, which typically reflects either the owner's personal interests or aversion to risk. Non-operating assets, such as fine art and vacation homes, may be owned by the company, but may be used for the owner's pleasure.

Or the owner may have excess assets like additional inventory or cash on hand simply because it's more comfortable for him or her to operate that way. In these cases, excess value is more a reflection of company ownership than of calculated operational or financial decisions. Experienced business valuation professionals are aware of these issues and will consider them when assessing smaller companies.