Valuation of Family Businesses
A case study

Filosofie kandidatuppsats inom Företagsekonomi

Författare: Claesson, Johan
Eriksson, Sofia
Wengbrand, Frida

Handledare: Greve, Jan

Jönköping: Juni 2005
Valuation of Family Businesses

A case study

Bachelor’s thesis within Business Administration

Authors: Claesson, Johan
         Eriksson, Sofia
         Wengbrand, Frida

Tutor: Greve, Jan

Jönköping: June 2005
Kandidat uppsats inom Företagsekonomi

Titel: Valuation of Family Businesses – A case study

Författare: Claesson, Johan
           Eriksson, Sofia
           Wengbrand, Frida

Handledare: Greve, Jan

Datum: 2005-06-03

Ämnesord: Företagsvärdering, familjeföretag, förvärv, immateriella tillgångar

Sammanfattning

Bakgrund

Majoriteten av alla svenska företag är familjeföretag. Forskning inom området har inte be-
drivits i någon större utsträckning förrän på senare år. Därtill kommer att forskning inom
värdering av familjeföretag är närmast obefintlig. Familjeföretag skiljer sig på många sätt
från icke-familjeföretag, t.ex. när det gäller kultur, ägande och ledning. Härav finns det an-
ledning att tro att familjeföretag värderas annorlunda än icke-familjeföretag.

Syfte med uppsatsen

Syftet med denna uppsats är att beskriva hur värdering av familjeföretag går till från ett
uppköpande företags synvinkel.

Metod

För att utföra denna uppsats har ett kvalitativt, hermeneutiskt tillvägagångssätt använts för
att förstå helheten av fenomenet familjeföretags värdering.

Vi har genomfört en fallstudie bestående av tre familjeföretags uppköp gjorda av Företag X
som noggrant har studerats.

Slutsats

När ett familjeföretag värderas är det avgörande att ha erfarenhet, branschkännedom, intui-
tion och framför allt kunskap och erfarenhet om familjeföretag. De immateriella tillgån-
garna i ett familjeföretag, som till exempel rykte, kultur och kunskap bidrar tillsammans
med olika värderingsmodeller till ett rättvist värde av familjeföretaget.
Bachelor’s Thesis in Business Administration

Title: Valuation of Family Business – A case study

Author: Claesson, Johan
        Eriksson, Sofia
        Wengbrand, Frida

Tutor: Greve, Jan

Date: 2005-06-03

Subject terms: Business valuation, family business, acquisitions, intangible assets

Abstract

Background

The vast majority of all Swedish companies are family businesses. Research within the field of family businesses has not until recent years been developed. Moreover, the research regarding valuation of family businesses is close to non-existing. Family businesses differ in many ways from non-family businesses, for example when it comes to culture, ownership and management. Hence, there is a possibility that family businesses are valuated differently from non-family businesses.

Purpose of this thesis

The purpose with this thesis is to describe how valuation of family businesses is done from the perspective of an acquiring company.

Method

For this thesis a qualitative, hermeneutic approach was applied in order to understand the whole picture of the valuation of the family business phenomenon.

A case study approach was carried out by carefully studying three acquisitions of small private family businesses in the service sector made by Company X.

Conclusions

The crucial skills to possess are experience, industry knowledge, intuition and most of all family business knowledge and experience when determining a fair value of a family business. The intangible assets of a family business, for instance reputation, culture and knowledge, together with different valuation methods contribute to the estimation of the value of a family business.
# Table of content

1 Introduction........................................................................................................ 1  
1.1 Background........................................................................................................ 1  
1.2 Problem.............................................................................................................. 1  
1.3 Purpose............................................................................................................... 2  
1.4 Delimitation ..................................................................................................... 2  
1.5 Disposition of the Thesis.................................................................................. 3  

2 Frame of Reference ......................................................................................... 4  
2.1 Introduction ....................................................................................................... 4  
2.2 Definition of family business ........................................................................... 4  
2.3 Family business vs. non-family business ....................................................... 5  
2.3.1 Strengths ..................................................................................................... 6  
2.3.2 Weaknesses ............................................................................................... 8  
2.4 Valuation of family businesses ....................................................................... 9  
2.5 Valuation methods ......................................................................................... 10  
2.5.1 The net worth model ................................................................................ 10  
2.5.2 Discounted Cash Flow (DCF) .................................................................. 11  
2.5.3 NUTDEL ................................................................................................. 12  
2.5.4 Valuation determined on an earnings basis with persistent profit .............. 12  
2.5.5 Goodwill ................................................................................................... 13  
2.6 Multiples ......................................................................................................... 13  
2.6.1 Trading multiples ....................................................................................... 13  
2.6.2 Transaction multiples ................................................................................ 14  

3 Method........................................................................................................... 15  
3.1 Introduction ..................................................................................................... 15  
3.2 Pre-understanding ......................................................................................... 15  
3.3 Choice of method ............................................................................................ 15  
3.3.1 Qualitative vs. Quantitative study .......................................................... 15  
3.3.2 Hermeneutic approach ........................................................................... 16  
3.3.3 Inductive vs. Deductive approach ......................................................... 16  
3.3.4 Case study approach ............................................................................... 16  
3.3.5 Interview .................................................................................................. 17  
3.4 Method for analysis ....................................................................................... 17  
3.5 Reliability and validity .................................................................................. 18  

4 Results........................................................................................................... 20  
4.1 Company X - introduction ............................................................................ 20  
4.1.1 Intangibles that affect the value ............................................................... 20  
4.1.2 Financial facts that affect the value ......................................................... 22  
4.1.3 Determining the final value .................................................................... 23  
4.2 Valuation of Family Business 1 ..................................................................... 23  
4.3 Valuation of Family Business 2 ..................................................................... 26  
4.4 Valuation of Family Business 3 ..................................................................... 29  

5 Analysis.......................................................................................................... 32  
5.1 Intangibles that affect the value ..................................................................... 32
Figures
Figure 2.1 The family Business Universe (Astrachan & Shanker, 2003). ...... 5
Figure 3.1 The hermeneutic spiral (Eriksson & Wiedersheim-Paul, 2001). .. 18

Table
Table 4.1 NUTDEL-calculations for FB 1....................................................... 24
Table 4.2 Valuation determined on an earnings basis with an estimated profit for
   FB 1............................................................................................................ 25
Table 4.3 Balance sheet for FB 1. ................................................................. 25
Table 4.4 Profit & Loss accounts for FB 1. .................................................... 25
Table 4.5 The net worth of FB 1. ................................................................. 26
Table 4.6 Goodwill calculations for FB 1. ..................................................... 26
Table 4.7 NUTDEL-calculations for FB 2....................................................... 27
Table 4.8 Valuation determined on an earnings basis with an estimated profit for
   FB 2............................................................................................................ 27
Table 4.9 Balance sheet for FB 2. ................................................................. 28
Table 4.10 Profit & Loss accounts for FB 2. .................................................. 28
Table 4.11 The net worth of FB 2. ................................................................. 28
Table 4.12 Goodwill calculations for FB 2. .................................................... 29
Table 4.13 NUTDEL-calculations for FB 3..................................................... 30
Table 4.14 Valuation determined on an earnings basis with an estimated profit
   for FB 3....................................................................................................... 30
Table 4.15 Balance sheet for FB 3. ............................................................... 30
Table 4.16 Profit & Loss accounts for FB 3. .................................................. 31
Table 4.17 The net worth of FB 3. ............................................................... 31
Table 4.18 Goodwill calculations for FB 3. .................................................... 31
1 Introduction

‘Valuation of companies is more an art than it is a science’ (JP Morgan Investment Bank).

1.1 Background

The family businesses constitute a vast majority of all companies active in Sweden (Gandemo, 2000). Depending on what definition of family business that is applied, a variety between 54%\(^1\) and 96%\(^2\) of all companies in Sweden are classified as family businesses. Even though the phenomena of family owned businesses has existed over a very long period of time, the research within the area goes back only to 1975. Between 1975 and the early 1990s the research mostly consisted of anecdotes and minor personal observations. Not until recent years the research has developed into deeper insights (Poza, 2004).

In this thesis the term family business refers to a business in which the majority of ownership and management are held by the same persons and to the fact that it perceives itself as a family business. Family businesses are in many ways different from non-family businesses. Each and every of these family businesses are unique and shaped by their own family culture and personal values (Leach & Bogod, 1999). According to Yegge (2002) family controlled businesses are associated with higher firm performance since families have stronger incentives to maximize company value. In many cases the family reflects upon the personal reputation and therefore treats the business as a member of the family. The intangible assets in a family business are mainly represented by the culture within the company walls. These invisible assets are hard to discover and understand from an outside perspective (Aronoff, Astrachan & Ward, 2002). Intangible assets are by its nature complicated to value because of its uniqueness and inseparableness from the company. It is impossible to estimate the exact value of intangible assets since the knowledge of expected future returns is imperfect (Barker, 2001). Before a takeover these intangible assets should be taken into consideration since they can affect the price of the company both negatively and positively. For example, keeping the family management will usually result in a higher price because of the fact that the intangible assets are kept within the acquiring company. On the other hand, if they no longer work for their own economic interests the need of supervision, control system or strong incentives will occur and that might affect the value negatively. These are some of the factors that make family businesses so hard to value.

After doing research on this it is understood that not much work has been done on examining the relationship between valuation and family businesses. Problems and benefits affect the value remarkably and yet there is no guideline in how to determine a family business’ value whatsoever. Such a guideline would be helpful for both acquiring companies and for family businesses about to be acquired.

1.2 Problem

Even though there are a lot of generally accepted business valuation models, there is a possibility that these are insufficient when valuating a family business. The reason for this is that family businesses are in many aspects, such as culture and ownership structure, different from non-family businesses and therefore might be valued differently. It will come a

---

\(^1\) Emling, 2000

\(^2\) Gandemo, 2000
time for every company when it needs to be valued and since the majority of the Swedish companies are classified as family businesses it might be of great interest for both acquiring companies and attractive family businesses to gain practical insight in the art of the valuation of a family business. The reasons for the valuation differ from case to case but the most common motives are mergers, acquisitions, change of generations (succession), inheritance or as a basis for credit granting. This challenge leads to the following question;

How does an acquiring company value family businesses?

1.3 Purpose

The purpose of this thesis is to describe how valuation of family businesses is done. This will be carried out from the perspective of an acquiring company in order to increase the understanding within this area.

1.4 Delimitation

This thesis aims to describe how Company X values a family business before an acquisition. Company X is one of the leading actors within electric, mechanic and energy services on the Swedish market and has over the last decade made around fifty acquisitions of small family businesses. In this thesis a case study will be applied based on information on acquisitions of small family businesses that provide services described above. Since we are limited in time and by the willingness of companies to share sensitive information, one company will be studied solely.

In case studies only a single or a few cases are studied thoroughly but this can affect the possibility of generalizations. Generalizations in case studies might instead be labeled petite generalizations since they are generalizations that regularly occur in the specific case but might not be complete for a whole population of something (Stake, 1995). A small number of observations can be justified by the fact that it provides a ‘thick description’ of the problem that probably would not be possible in cases of numerous observations (Ghauri, Grönhaug, & Kristianslund, 1995).

However, within the study of Company X three acquisitions will be described in order to increase the trustworthiness within this subject. Thus, the outcome of this study is most suited as guidance on acquisitions of small private family businesses in the service sector.
# 1.5 Disposition of the Thesis

In this chapter the background, problem, purpose and delimitation of this thesis are presented and discussed. It also states the reasons for why the chosen subject is of great interest and to whom.

This chapter intends to present and describe relevant theories regarding the purpose of this study. It aims to use the theory found for interpreting the empirical observations obtained. The chapter starts with a description of theories regarding family businesses and ends with a presentation of the most commonly used valuation methods.

This chapter presents and explains the method chosen in order to fulfill the purpose of this thesis.

This chapter describes how valuation of family businesses is performed in Company X. The chapter starts with an introduction of Company X and continues with a description of the intangibles that affect the value of a family business and which valuation methods that are used when valuating a family business. The chapter ends with a description of the three cases – three acquisitions.

This chapter intends to analyse the empirical findings with relevant theories. It will start with presenting the intangibles that affect the value of a family business. It is further analysed which valuation methods that have been used in Company X when a family business is about to be acquired. The chapter ends with an analysis of the three cases that have been studied and finally a comparison between the three cases.

In this chapter the thesis is concluded. A description of how Company X values family businesses is presented.

This chapter discusses the outcome of the study conducted.
2 Frame of Reference

This chapter intends to present and describe relevant theories regarding the purpose of this study. It aims to use the theory found for interpreting the empirical observations obtained. The chapter starts with a description of theories regarding family businesses and ends with a presentation of the most commonly used valuation methods.

2.1 Introduction

A lot of research has been conducted on family businesses and valuation, separated from each other. When the two subjects are brought together the literature is almost non-existing. This is rather strange when thinking about how many family firms there actually are in Sweden and the rest of the world. The reasons for a valuation differ from case to case but the most common motives are mergers, acquisitions, change of generations (succession), inheritance or as a basis for credit granting.

2.2 Definition of family business

‘Family businesses are unique because they are composed of a flow through time of people with conflicting needs, concerns, abilities and rights, people who also share one of the strongest bonds human beings can have – a family relationship’ (Danco, 1993, p51). This is what makes family business different from non-family business; it contains so much more than just a business (Danco, 1993). It is hard to measure how many family businesses there are because there is no widely agreed upon definition of what it is (Brockhaus, 1994; Dyer, 1986; Ward & Aronoff, 1990).

Experts within the area of family business research use their own definitions and criteria to distinguish these businesses (Astrachan & Shanker, 2003). The single word family is hard to define as divorcement figures increase and new forms of partnerships emerge, like cohabitant relationships for example (Gandemo, 2000). Even if a definition would exist it would be hard to measure family businesses because the characteristics are intangible and therefore hard to collect. This is the main factor why more research within this area has not been conducted (Astrachan & Shanker, 2003). The definitions of a family business all strive towards the same direction with minor changes and additions. A selection of definitions are presented below.

A family business is a company that is owned and controlled by one or several families who also have an active role in the management of the company. Family businesses are special by its nature and culture compared to non-family businesses, they have the unique strengths that characterizes it; knowledge and experience transfer between generations, rapid decision making processes and a large portion of commitment and involvement. Most Swedish family businesses belong to the category that the European Union (EU) defines as micro businesses, that is less than ten employees (Johansson & Falk, 1998).

A family business according to Leach and Bogod (1999) is a business that is influenced by a family or by a family relationship, and that perceives itself to be a family business. They further argue that one family should control either the entire company and/or more than fifty percent of the voting shares, and/or that a considerable part of the top management positions are held by family members.

Astrachan and Shanker (2003) uses a dart-board shaped model (see figure 2.1) with three different levels of how to perceive a family business. The outer ring includes family partici-
family participation and control of strategic direction. This is the broadest definition of this model and a level that has to be reached in order to be called a family business. The middle ring sharpens the definition and adds two criteria; founder/descendant runs the company and intends to remain the business in the family. These criteria separate those companies where the family has chosen a non-family manager of the firm from each other. To hit ‘bulls eye’ and be considered a true family business the firm must include multiple generations and more than one member of the family must hold a managerial responsibility.

Ward and Aronoff (1990) shortly state that when a firm has two or more members from one family in a leading financial position it is considered a family business.

According to Rosenblatt, de Mik, Andersson and Johnson (1985) a family business is defined as involvement between at least two family generations and that the succession between them has involved a discussion regarding the family business and its policy, goals, and general family interests.

Ward (1987) considers a business as a family business when it will be passed on within the family for the benefit to future generations and that the next generation remains in managing positions and in control.

Henceforth, when the term family business is used in this thesis, it refers to a business in which the majority of ownership and management are held by the same persons and to the fact that it perceives itself as a family business.

2.3 Family business vs. non-family business

A family business has hidden strengths and weaknesses that make it different from a non-family business. These intangible assets are unique for every individual firm and if treated right a competitive advantage. Leach and Bogod (1999) argues that these attributes creates a unique atmosphere that only exists in a family business. Conducted research and findings
are presented below and can be used as an explanation to how and why family businesses
differ from non-family businesses.

2.3.1 Strengths

Commitment, among with tradition, quality and service, is the hallmark of a family business according to Gallo, Tàpies and Cappuyns (2004). Littunen (2003) argues that a family business is driven and motivated by the fear of unemployment and that it creates commitment. The family business becomes a big part of the involved family’s whole life. The special bond between the family and the firm, represented by ownership, management and family features, becomes one unit and thereby creates commitment (Hoy & Verser, 1994).

A special and sometimes unique knowledge, way of doing things, is a common phenomenon within family businesses that could be treated as a strength. It could be either a technological or commercial know-how. If this knowledge is not possessed by competitors it is crucial to keep it that way and according to Donnelley (1988) it is easier to keep this sort of information and knowledge within the family business walls than in a non-family business due to the loyalty among the employees in a family business.

A family business is considered flexible in many ways. Willingness to work no matter the hour of the day, any day, and planning the paying of salaries/wages according to the liquidity are vital and often unique aspects that separates a family business from a non-family business (Leach and Bogod, 1999). Perrow (1989) talks about how family firms rather share the work load than have too many employees, he calls this phenomenon underemployment.

The ability to rapidly adapt to changes is much due to a short decision process, or speedy decisions as Leach and Bogod (1999) calls them. The decision making in a family business is mainly centralised, often only a one man job, and therefore the decisions can be done without time delaying consulting. In a non-family business the process is often long and slow due to a decentralised organisation structure and the fact that the organisation is owned by other parties than the employees and their interests comes first. A family business can stop what they are doing and start doing something else by the blink of an eye while a non-family business often do not have that kind of flexibility (Leach & Bogod, 1999).

Survival: The family business becomes such a vital part of the family’s total income that long time survival is more important than short time profit making. Leach and Bogod (1999) argue on how family businesses often have a strategic plan and objectives for the next ten to fifteen years, this is rather unusual in a non-family business. This way of long-term thinking is mainly an advantage but if the transformation into reality fails it might become a disadvantage (Leach & Bogod, 1999).

Risk averse (stable): Family businesses often tend to be better long-term thinking than non-family businesses. Littunen (2003) found in her research that family firms are less profit and growth oriented than non-family businesses and focus more on long time survival, and that could be an explanation to their stability. This theory is also supported by Donckels & Fröhlich (1991). They further states that this phenomenon is much due to a strategic perception towards reduced risk taking. Innovations in a family business are treated more as a risk than an opportunity, a conservative attitude that is less found in non-family businesses (Donckels & Fröhlich, 1991). The risk averse attribute is double sided, it could also be perceived as a weakness if applied in a way that will prevent development.
Frame of Reference

Culture. As a family business grows through an evolutionary process it also matures and creates its own set of culture (Dyer, 1986). The culture is built on four levels; artefacts (logo, jargon, myths, stories etc.), perspectives (how to think and act in an unknown situation), values (general principles) and assumptions (basic principles where values are rooted). The culture of a family business plays a significant role in the survival of it (Dyer, 1988).

Denison, Lief and Ward (2004) have conducted a study in which they critically examined family business culture and performance in comparison to non-family businesses. The study also aimed at investigating in what ways the culture of family businesses are different from non-family firms. The study was conducted between the years of 1998 and 2003. The family businesses in the study represented many different industries with a spread geographic location, different ownership structure and size. The results of the culture profile study were compared with the results from a culture profile study with non family businesses. All the participating organizations had to have many respondents, who all had to be representative for the organization’s population, included in the survey. To be classified as a family business the firms had to have either family members holding key positions, family voting ownership of at least 15% or family control of the governance. The corporate culture in the studies were divided into four main characteristics; adaptability, mission, consistency and involvement. In turn, each of these four characteristics was further divided into three sub-characteristics leaving a total of twelve indices;

- **Adaptability**: Creating change, Customer focus, Organizational learning
- **Mission**: Strategic direction & intent, Goals & objectives, Vision
- **Consistency**: Core values, Agreement, Coordination & integration
- **Involvement**: Capability development, Team orientation, Empowerment

The study showed that the family businesses had higher ratings on all twelve indexes. Two aspects of consistency and two aspects of adaptability showed greater marginal significance than the others, namely core values and agreement (consistency) and creating change and organizational learning (adaptability). The results showed that family businesses possess several cultural advantages compared to non-family firms and that this gives family businesses a distinct competitive advantage. According to Denison et al. (2004) is the most plausible explanation of these results the founder’s values in the culture of the family company. The foundation is usually entrepreneurial spirit and this spirit lives on generation after generation creating distinct core values but also a learning and flexible environment, hence family business culture is difficult to copy and is therefore the source to competitive and strategic advantage (Denison et al., 2004).

Reliability and pride. This characteristic is a combination of the two earlier mentioned, commitment and stable culture. Family businesses are in general very solid and reliable; many customers prefer to do business with this kind of well established companies, a business partner that the buyer can trust and create a long term relationship with. In a family business this is often the case due to the fact that the family members take great pride in their work and put their family reputation at stake in every situation concerning the business (Leach & Bogod, 1999; Ward & Aronoff, 1991). According to Stainer (2002) there is an obvious connection between social behaviour, reputation and personal networks, and the financial performance of a business. The people involved in a family business are in general, compared to non-family business employees, very proud of the company they work in. ‘Having your family’s name on the door of your business intensifies concerns for quality and service’ (Ward & Aronoff, 1991, p 44). Leach and Bogod (1999) confirms this when claiming that ‘hidden forces’ are not the only advantage in a family business; there are also
revealing characteristics originating from pride and commitment and that the family businesses in general are; friendlier to customers, have more deep knowledge (core competence), more skilful in what they do and have a higher level of service and customer care.

A family business has in general very loyal employees. The internal organisation is marked by commitment to the company and this affects the employees and develops a bond between the employees and the company. Another advantage for family businesses towards non-family businesses concerning employees is the law of Parkinson (Donnelley, 1988). This law means that in a non-family business managers use more work force and employees than in a family business. The reason is twofold; managers like for their own satisfaction and prestige to have as many employees below them as possible and that managers help each other by creating work positions even when it is superfluous (Nationalencyklopedin, 1994).

Donnelley (1988) claims that family businesses have financial benefits over non-family businesses. In his research he has found that family businesses seem to have advantages when applying for a bank loan or asking for credit with a supplier because of the family related business. This is also applicable when there is a certain risk involved, for example that the company needs a bank loan to survive. Another close related financial advantage is loyalty from stockholders and the common interest for the business between stockholders and the management of the business (Donnelley, 1988).

2.3.2 Weaknesses

**Rigidity:** Rigidity is about unwillingness to change and adapt to changes. Things have been done in a special way for a long time and it is either easier not to change this routine or it is simply not being detected as a problem (Leach & Bogod, 1999).

**Business challenges:** This characteristic can be divided into three sub-categories; modernising outdated skills, managing transitions and raising capital. The first category, modernising outdated skills, could develop into a problem if the business’ product or service becomes obsolete due to a sudden change in either technology or in the market place. According to Leach and Bogod (1999) family firms are less prepared to deal with a situation like this because of its strong tradition and often stable background. The reliability on one single concept (product, service etc.) that has been passed on through generations is a key factor to this possible problem. The second category within business challenges is managing transitions. A change in the managing position often includes radical changes and uncertainty within the organisation and is never easy apply, especially not within a family business. These changes that the new manager wants to make could create a rift between him and the staff that liked the old manager’s way better. In a family business this means it could create a rift between family members. A change from father to son for example could create arguments when the son wants to put his own character on the business and the father want to keep things as they were when he was around. The third and last sub-category is about raising capital. In comparison with a non-family business, often with a large shareholder base, a family business has limited capital raising options. Raising capital from outside the family most often involve long-term investments like buildings and plants. Much of this is due to the fact that a family business and its owner want to maintain total control and to be as independent as possible; this is no longer possible when outside the family investors are involved (Leach & Bogod, 1999).

**Succession planning** involves the process of shift between generations, to pass the family business on to the next generation. "The lack of succession planning has been identified as one of the most important reasons why many first-generation family firms do not survive their
founders” (Lansberg, 1988, p 119). This is due to dependency of the founder’s qualities in leadership, motivation, business relationships and technological know-how (Lansberg, 1988). Keeping the business within the family through generations demands careful planning (Lansberg, 1988; Ward 1987). This is a subject that many family business owners neglects, puts aside and trusts the future to solve itself (Danco in Ward, 1987). Ward (1987) states that keeping the business within the family is very important to many company owners and that it is a very difficult task to actually do. Careful planning for the future of the business can help it to; (1) grow and be profitable, (2) create a strategy for the future, (3) prepare succession, (4) maintain positive image among non-working family members, and (5) create a philosophy and culture of the company (Ward, 1987). The family business and non-family business differ in succession thinking. The family business concentrate most on a relationship level whereas the non-family business have a formalized approach and values education and experience most when choosing successor (Fiegener, Brown, Prince & File, 1994). A commonly used word for this is nepotism. This means that relatives have an advantage over merits (Donnelley, 1988).

Another problem, which also involves succession, is leadership qualities, or the lack of it. Successors to a family business tend to focus more on learning the business than learning how to lead it (Ward & Aronoff, 1994). Littunen (2003) has found that group management is more common in a non-family business than in a family business. A family business often relies on one single person while a non-family business spreads its decision making on several employees. This means that a non-family business are less dependent and vulnerable if something would happen to the decision maker/s. It also means that key-decisions are made from one person’s angle in the family business case while in a non-family business several opinions are brought up to consideration (Littunen, 2003).

Other aspects that falls under the succession category are the emotional issues, relationships. Hoover (2000) talks about the importance of an understanding between the family and the business. It is of great importance to keep a balance between the family and the business. The nature of the family and the business can be very different, the family is about cooperation and equality while the business is about competition and survival, this could create a problem (Ward & Aronoff, 1993; Donnelley, 1988). The mix of family and business is supposed to create a value that means more together than as single objectives. It should not have to be a question of having to choose between one of them. This is a key factor why a family business is different from a non-family business, but it could also create problems (Hoover, 2000). All relationships, both within and outside the family business, have an effect on it, good or bad (Danco, 1993).

Donnelley (1988) discusses poor profit discipline in family businesses. This is due to the fact that members of a family business focus too much on quality, personal relations etc. and tend to forget about being profitable. Another reason is that family businesses often use poor cost-control systems. The willingness to take action when the costs are increasing is often the determination of success or not (Donnelley, 1988).

2.4 Valuation of family businesses

Wright (1995) discusses the problem with valuation of a family business. He emphasizes on the fact that the value is subjective and the valuation of a family business is never precise. He does claim that weighing historical financial information, the present status of the business and the business’ future operations together to come up with a ‘fair’ value does the valuation process. It is of importance to remember that not all of a company’s assets appear on the balance sheet. The company might possess both valuable assets that are gener-
ally included in ‘goodwill’, but also contingent burdens that do not appear as liabilities on the balance sheet.

All these perspectives must be taken into consideration when determining a value of a family owned company. It is not an easy thing to do, but a combination of approaches would in all probability be the best measurement (Wright, 1995).

2.5 Valuation methods

Valuation of companies is usually a complicated process and it is not easy to obtain an objective value. The history, the future and the present situation of the company needs to be taken into consideration as well as economic book values and non-economic factors like business concepts, market situation, organization and products. The value of a company can also change if the new ownership involves complications or special costs of different kinds for the new owner (Johansson & Falk, 1998). Valuation is a complex concept since different perspectives can give different values of a company. The value lies within the eyes and interests of the beholder (Hägg, 1991). In most cases it is difficult to obtain a definite value of a business since different interested parties have different views on how to estimate the value. Naturally the buyer wants to pay as little as possible while the seller wants to receive as much money as possible. These differences can cause conflicts between a buyer and a seller (Hult, 1998).

There are many generally accepted valuation methods but different methods are used for different companies. Some valuation models are better suited for listed companies and other models are better applied on private companies. Listed companies already have a price tag; the share price. The main task in valuation of publicly traded companies is therefore to decide if there is a surplus value or an undervalue on the traded shares, this since the share price does not necessarily reflect the true and fair value. Valuation of a private company is thus a more complicated task. Private companies are not usually valued until a certain situation demands it, for example mergers, acquisitions, change of generations, inheritance or as a basis for credit granting. Another important distinction is that the value of a private company usually is closely related to the owner since he or she has personal contacts that determine the success of the business. To obtain a fair value these aspects should be taken into consideration (Nilsson, Isaksson & Martikainen, 2002).

It is common procedure to use several measuring methods to gain a fair value (Yegge, 2002). According to Hult (1998) private companies almost exclusively uses the net worth method and valuation determined on an earnings basis. These are also considered to be the traditional methods since they have been applied for a long period of time.

Company valuation is a subject that is well explored and a lot of literature is available. In this section we will describe some of the most frequently used methods for company valuation.

2.5.1 The net worth model

One method that is commonly used when valuing a small private business is the net worth model. This method is often seen as a complement and a foundation to valuation from earnings. This since it represents the value of the equity and a determined price based only upon this model would basically mean an exchange of money. When valuing a company according to the net worth model the starting point is the balance sheet. The aim is to find the real value of the assets and liabilities of the company. In the balance sheet a company’s
assets, liabilities and equity are stated. If the liabilities are deducted from the assets the equity is found, hence; Assets – Liabilities = Equity.

The book-values in the balance sheet are usually not the same as the real values. Therefore these book values needs to be adjusted for real values since it is these that are interesting in business valuation, hence the hidden reserves are dissolved. The new adjusted value is called adjusted equity, which is also what the company is worth according to this method. The purpose of the valuation determines which values that are real. The market value/replacement cost is used as the real value if the business is going concern. The break-up value is used if the business is to be liquidated. The latter is therefore not so common to use when valuing a going concern. Examples of items that generally are objects for adjustments are real estate, stock-in-trade, accounts receivable, equipment and shareholdings. It is also common to consider the untaxed reserves which creates deferred tax liabilities when adjusting the value. Hence the net worth method can be summarized as follows;

\[
\text{Real value of the assets} - \text{Real value of the liabilities (with or without adjustment of deferred tax liabilities)} = \text{Net worth (Adjusted Equity)}.\]

A disadvantage with the method is that it does not take into consideration the value added that the assets of the company might create. The model also demands information about real values that cannot be found in annual reports (Nilsson et al., 2002).

If a company has intangible assets this complicates the valuation process. It is difficult to put a real value on intangible assets and therefore these have to be estimated (Johansson & Falk, 1998).

### 2.5.2 Discounted Cash Flow (DCF)

The DCF model is commonly used to estimate the value of a company. It is a measure of cash flow, which represents the return to both debt holders and shareholders (Barker, 2001).

The DCF model is based on the sum of all future discounted cash flows. Some of the reasons why the DCF model has become so popular and widely used is because of the fact that the model works well for all companies, from the smallest companies to mature multinational companies and it corresponds well to market values.

To calculate the free cash flows (FCF) means calculating the cash flow to which the enterprise’s claimants have access. It is common to divide the future of a company into two periods; the explicit period and the terminal value period. During the explicit forecast period free cash flow are calculated for each individual year to predict the cash flows with a reasonable accuracy. The number of explicit years differs depending on company, situation and industry.

The only rule to follow is that the cash flow must reach a constant level throughout the period but the further the forecast lies into the future the more inaccurate the calculated free cash flow will be. Therefore, an explicit forecast period longer than ten years is rarely recommended. Once the company value from the explicit period is determined, the next step in order to get the firm value (FV) is to add the terminal value (TV), that is, the present value of all free cash flows after the last year of the explicit period to infinity (Frykman & Tolleryd, 2003).

The model is built up by dividing the calculation into four sections; estimating the weighted average cost of capital (WACC), calculating the free cash flow, computing the terminal
value and discounting and final corporate value. The WACC is calculated by weighing the cost of debt with the cost of capital in order to reflect the risk inherent in the forecasted future cash flows (Frykman & Tolleryd, 2003).

The formula has the following appearance;

\[
FV = \frac{FCF_1}{(1+WACC)} + \frac{FCF_2}{(1+WACC)^2} + \ldots + \frac{FCF_n}{(1+WACC)^n} + TV
\]

2.5.3 NUTDEL

NUTDEL is a Swedish shortening for 'nuvärdet av framtida utdelningsbara medel' and is roughly translated as 'the present value of future distributable earnings'. The method is developed by Hult (1998) and has its basis in investment theory, this because the fact that the valuer can see the company as an investment that should generate returns. The NUTDEL method is appropriate when valuing all sorts of companies. Service companies can with advantage apply this method since it takes the human resource’s ability to contribute to the result into consideration.

Since there is no true and fair value of a company this method gives an interval in where the value can be found. In this method the company value is the present value of all the future dividends the company can generate for its owner. Based on different forecasts and assumptions in growth that different investors and valuers have, the value changes within the interval.

The procedure can be divided into three phases;

- **Analysis**: In this phase the historical development of the company is examined by analyzing former balance sheets and profit and loss accounts. This gives the basis for estimating the future development. The company’s position among competitors, information about business cycles and product life cycles and the owners importance of future development are all examples of factors that are analyzed in this phase.

- **Forecast**: The information gathered in the analysis phase gives the foundation for the forecast of future development. This is usually expressed in forecast balance sheets and profit and loss accounts. The forecast should in general consist of a seven year period of time but it is the accessibility of data that determines the time-span. Generally an optimistic, a normal and a pessimistic scenario is produced in order to be assured that all possible outcomes are known and to minimize the risk.

- **Calculation**: In this phase alternative scenarios are created. This is done in order to show different outcomes when different variables are changed. It is therefore easy to see how the value is affected if a factor is changed. The calculation results in a value of the company (Hult, 1998).

2.5.4 Valuation determined on an earnings basis with persistent profit

This method is mostly suitable on small private businesses. The starting point is the company’s profit and loss accounts and the aim is to estimate a 'persistent profit' which can
represent the company’s production of value for all time. Usually a weighed average of the latest year’s net profit is used when calculating the persistent profit. The net profits are adjusted for extraordinary items which have affected the profit and that do not represent a normal business transaction (Nilsson et al., 2002).

When the persistent profit is known it is divided by the required return to obtain the value of the business, hence the following formula is used:

\[ V = \frac{p}{i} \]

\( V \) = the calculated value
\( p \) = the persistent profit
\( i \) = the required return

When using this method it is common to use several different required returns in the calculation to see how the value changes when these are different (Hult, 1998; Nilsson et al., 2002).

### 2.5.5 Goodwill

It is of great importance to establish how much goodwill the acquiring company can afford when bidding on a company. Frykman and Tolleryd (2003) define the occurrence of goodwill as the cost of acquiring assets or other businesses in excess of their book value. It is of every acquirer’s greatest interest to keep the goodwill posts as low as possible in order to avoid large amortizations that will affect the result negatively. Goodwill is therefore a crucial issue to most businesses. It can cause problems when the whole is being greater than the sum of the parts (Barker, 2001). Baron (1996) further defines goodwill or ‘blue sky money’ as the quality of a company that makes the customers come back in order to be treated as well as they were the previous time.

### 2.6 Multiples

Beside the traditional methods for estimating a firm’s value there are measurements called multiples. These multiples are based on values on perspective and historical earnings. Multiples give a value relative to peers and market as a whole and provide a sort of benchmark. Two types of multiples are discussed; trading multiples which are dependent on growth rate and discount rate, and transaction multiples that works as benchmarks and include premiums such as synergy effects.  

#### 2.6.1 Trading multiples

A trading multiple analysis is used to see how selected companies trade relative to the business being valued. It is interesting to use this tool because of its independence of the company’s capital structure. Most investors focus on a few key multiples and the three that are most commonly used are;

---

3 Information gathered from lectures held by JP Morgan at the European Business School, Germany, 2004.
Frame of Reference

- **FV/EBIT** (Firm Value/Earnings Before Interest and Tax (FV = Suggested Purchase Price + Interest-Bearing Debt))

This is a formula that calculates how many times EBIT the firm is worth. The advantage with this model is that it is independent of leverage but on the other hand can it be distorted by different depreciation/accounting policies. That is why the following formula can be more appropriate.

- **FV/EBITDA** (Firm Value/Earnings Before Interest, Tax, Amortization and Depreciation (FV = Suggested Purchase Price + Interest-Bearing Debt))

In this case it is calculated of how many times EBITDA the firm is worth. This way of calculating is also independent of leverage but it also includes the important factors of amortization and depreciation. Hence, it reflects the value in a fair way.

- **P/E** (Price/Earnings)

This multiple is widely used among investors. It reflects how many times the earnings that the price will be. This is not ideally applicable on high growth companies due to their negative or not stable earnings but suits on the other hand small stable companies well but only if the compared companies are almost identical. 

### 2.6.2 Transaction multiples

Transaction multiples are historical multiples based on transactions that have already been announced and are in general used in order to be able to cross-check the prices in the M&A (mergers and acquisitions) market. It can be difficult to imply them though, since the reliable information about private businesses that were object of a transaction usually is limited and hard to find. It is crucial to keep in mind that the transaction amounts are a price and not a value since they might include an amount of premium.

When looking for these multiples it is of great importance to find the most comparable businesses. It is vital to find businesses that are similar in industry with similar products or services, size of the business, margins and relative market position. Recent deals are in most cases a more correct reflection of the values that the buyers are willing to pay.

---

4 Information gathered from lectures held by JP Morgan at the European Business School, Germany, 2004.

5 Information gathered from lectures held by JP Morgan at the European Business School, Germany, 2004.
3 Method

This chapter presents and explains the method chosen in order to fulfill the purpose of this thesis.

3.1 Introduction

The purpose of this study is to describe how valuation of family businesses is done. This will be carried out from the perspective of an acquiring company in order to increase the understanding within this area.

A case study will be conducted by doing an interview at Company X which has acquired many family owned businesses throughout the years. Three acquisitions will be described with help from the interview but also from calculations, balance sheets, profit and loss accounts and annual reports. Further, the data received will be analyzed from a hermeneutic perspective.

3.2 Pre-understanding

The research problem derives from an interest in business valuation and the phenomena of small family businesses. Together with associate professor Jan Greve a more narrow purpose was developed.

Since a hermeneutic spiral is used as an analytical tool, also described in section 3.3.2 and 3.3.6, it is crucial with a well developed pre-understanding. An extensive literature search was conducted concentrating on family businesses and business valuation. Furthermore, advanced searches in search engines like Jstor, ABI/InformGlobal, Ebrary and among the journals provided digitally were conducted. The ICE collection (Information Center for Entrepreneurship) in the Jönköping University Library has been of great importance when searching for family business literature. Ejvegård (2003) argues the importance of carefully consideration of which key words to use when searching databases. It is crucial to test different keywords in order not to miss out on any important writings. Examples of key words used are valuation, business valuation, family business, family owned businesses, closely held companies, takeovers, small businesses, intangible assets and also the Swedish translation of these words.

This pre-understanding is a prerequisite for being able to initiate the study.

3.3 Choice of method

Since our purpose is to describe how valuation of family businesses is done a qualitative, hermeneutic approach is chosen for this thesis. This method is suitable when making an observation to understand the whole picture of a phenomenon.

3.3.1 Qualitative vs. Quantitative study

A qualitative research method differs from a quantitative method in the sense that the findings are not based upon statistical or other methods of quantification. A qualitative method is based upon making one or a few observations; however, each observation can consist of many different aspects of the problem area. The small number of observations can be justified by the fact that this method provides a ‘thick description’ of the problem that probably would not be possible in cases of numerous observations. When it is desirable to under-
stand and uncover a phenomenon that one does not know so much about, as in this study, a qualitative method is requested. This method emphasizes on the understanding of theories. It focuses on observations and measurements in natural settings and provides a subjective ‘insider view’ and closeness to data (Ghauri et al., 1995).

3.3.2 Hermeneutic approach

The difference between positivism and hermeneutics is that positivism aims to describe and explain something using quantitative methods. Hermeneutics on the other hand seeks to understand the whole picture and gain insight into the chosen subject. Instead of a statistical result, which would be the case in a quantitative method, the aim is to use a hermeneutic method where the authors act as interpreters instead of dealing with statistical data. This thesis is carried out by using the method of the hermeneutic spiral (see section 3.3.6). This is a generally accepted method for interpretation and illustrates the hermeneutic course of action (Eriksson & Wiedersheim-Paul, 2001). This model is suitable for this thesis since it is a good tool in developing knowledge.

3.3.3 Inductive vs. Deductive approach

According to Ghauri et al.(1995), in doing research it is vital to establish what is true or false when it comes to the basis of theories. There are two ways of drawing conclusions and determine what is true and what is false; by induction or deduction.

According to Artsberg (2003) a deductive method is based upon an existing theory and seeks to test this to fortify, invalidate, adapt or develop it. The inductive method has its starting point in the empirical findings and aims to build up new knowledge that will contribute to new theories. The difference between the deductive and the inductive method is that the deductive method acknowledges that the data is ‘dependent on theories’ and that a theory is only supported when it is confirmed by empirical findings (May, 1997).

Hence, to fulfill the purpose of this thesis an inductive method is in some senses used since the aim is to describe how the valuation of a family business is done. The inductive approach is applied especially in the empirical chapter and in the analysis. According to Saunders, Lewis and Thornhill (2000) it can be helpful to use a theoretical foundation when analyzing the empirical findings even though the approach is inductive. Thus, a deductive approach is used to some extent since pre-understanding was gained based on existing theories. The deductive approach is applied especially in the theoretical chapter. Since nothing is black or white this thesis are from some perspectives inductive but from other perspectives it might also have a deductive approach.

3.3.4 Case study approach

A case study has been chosen for this thesis in order to describe how valuations of family businesses are done. A case study is characterized by the fact that few cases are studied from many different aspects. Generally a line, a company, a decision or a county is chosen and then a profound examination is performed. If the word describe is used in the purpose and problem of a thesis or in a research a case study is preferable. If two or more cases are carried out the prospect of comparison and reliability increases and therefore also the possibility of generalization (Eriksson & Wiedersheim-Paul, 2001). A case study is used when there is little theory and experience for guidance on a subject. The focus here is on seeking insights through the characteristics of the object rather than on testing existing hypothesis.
When research questions like ‘how’ and ‘why’ are being asked, a case study is the method that should be favored as a research strategy (Ghauri et al. 1995).

Yin (2003) suggests that when there is a possibility that something new and important can be learned, a case study method can be applied on an area that has rarely been examined and is unique by its nature.

According to Stake (1995) a case is studied in order to understand this one case and maximize what can be learned from it. The number of recommended cases to be studied depends on limitations in time and access. It is not always certain that the outcome of a study will be better when a large number of cases are studied than when a small number of cases are studied. Since this thesis is limited in time, one company is selected, but from this company three cases are studied, thus greater reliability can be obtained.

The case study consists of three different cases; each an acquisition that Company X has done. The case study was conducted from an interview (see below) but also from a collection of historical data such as annual reports, balance sheets, profit and loss accounts and calculations from the three acquisitions.

3.3.5 Interview

One part of the empirical findings of this thesis was conducted by a personal interview with the CEO of Company X. When looking for information that has not been documented it is necessary to turn somewhere else for that information. One way to go is to turn to people for answers. It is crucial to choose the right respondent in order to get the appropriate information for the purpose of the study. If the wrong person is being interviewed there is a great risk of lack of insight and understanding regarding the chosen topic (Merriam, 1988). Since the CEO of Company X is one of the persons who has the deepest insight and most information about the acquired companies he was chosen for the interview. Eriksson and Wiedersheim-Paul (2001) emphasizes the importance of preparing for an interview in order to receive relevant answers. It is vital to plan the interview carefully and make a list of questions – a catalogue of variables. It is also crucial to have a well-developed pre-understanding in order to avoid lack of competence that would occur during the session. Further more it is important to stay on the track and not go into irrelevant directions. Positive aspects when making a personal interview are the facts that the person who makes the interview can use relatively complicated questions, avoid misunderstandings and have the possibility to follow up with related questions (Eriksson and Wiedersheim-Paul, 2001). Though, a good interview is dependent on the fact that the right questions are being asked and for an inexperienced interviewer it is always preferable to have a detailed list of questions as a ground before doing more open interviews (Merriam, 1988). Another positive issue is that the interviewer can interpret the person being interviewed and see whether the person is well skilled within his/her subject or not. A disadvantage on the other hand could be the situation where it can be hard to ask sensitive questions because of the lack of anonymity (Eriksson and Wiedersheim-Paul, 2001). To avoid misunderstandings and irrelevant facts the interview was carefully planned and the main questions was sent to the CEO of Company X together with the background, problem statement and purpose in order for him to be able to gain insight in the study.

3.4 Method for analysis

In this study a hermeneutic spiral is used in order to interpret the data received. The spiral starts with a pre-understanding of the subject matter. It is vital that the interpreters study the
material available within the research area in order to get as much as possible out of the research topic and to be able to develop relevant research questions. This thesis started with studying the basic literature regarding family business and valuation to gain an understanding and insight in the subject and also developing questions and ideas considering the area under discussion (see figure 3.1). The next step in the spiral is called the dialogue. The reason why this part is called dialogue is based on the fact that it is a two way communication between the interpreters and a second source. Based on the dialogue the researchers make an interpretation which is the third step in the spiral. The first dialogue of this study occurred when an interview was conducted with Company X. These interpretations lead to new understanding in the subject matter. This new understanding leads to new questions and ideas which lead to a new dialogue and a new interpretation and the spiral goes on (Eriksson & Wiedersheim-Paul, 2001). Clarifying the objectivity of the authors helped in building up a trustful relationship with Company X. More information was received along the way that kept the study in the pattern of the hermeneutic spiral with new dialogues, interpretations and understandings. During the study an on-going process of dialogues and a constant need of new information from Company X has occurred.

Figure 3.1 The hermeneutic spiral (Eriksson & Wiedersheim-Paul, 2001).

3.5 Reliability and validity

Two crucial concepts in doing research are reliability and validity. These concepts are generally used when doing quantitative studies but they are also of great importance in qualitative studies. According to Kirk and Miller (1986) reliability is the extent to which a measurement procedure yields the same answer however and whenever it is carried out; validity is the extent to which it gives the correct answer. In qualitative studies validity is an issue of whether the researchers see what they think they see and how they interpret their findings.

Reliability and validity are together asymmetric. Perfect validity demands perfect reliability but perfect validity is not theoretically possible. On the other hand it is possible to achieve perfect reliability without any validity at all. To be able to obtain high validity and reliability the background, problem statement and purpose was sent to the CEO of the company before the visit so that he could be well prepared for the interview and also for him to gain deeper insight in the problem.

No study can be under perfect control and knowing what conclusions to make when findings either differ or agree depends upon the reliability (Kirk & Miller, 1986). True reliability can only exist if another researcher would draw the same conclusion in another time and place using the same research method (Eriksson & Wiedersheim-Paul, 2001).
Method

In case studies only a single or a few cases are studied thoroughly but this can affect the possibility of generalizations. Generalizations in case studies might instead be labeled *petite generalizations* since they are generalizations that regularly occur in the specific case but might not be complete for a whole population of something. Instead of generalization the essence of case studies is particularization. A particular case is selected and carefully studied, the primary object is not to see how it is different from others but what it is and how it is done. To be able to tell what is unique with a specific case knowledge about other cases is necessary (Stake, 1995). In this thesis three cases are studied and can therefore be compared to one another. This study is limited to make generalizations for Company X only and can therefore be thought of as petite generalizations.
4 Results

This chapter describes how valuation of family businesses is performed in Company X. The chapter starts with an introduction of Company X and continues with a description of the intangibles that affect the value of a family business and which valuation methods that are used when valuating a family business. The chapter ends with a description of the three cases – three acquisitions.

4.1 Company X - introduction

Company X is one of the leading actors within electric, mechanic and energy services on the Swedish market. It was established in 1958 and has close to 1000 employees in approximately 60 cities today, mainly in Sweden but also in Norway. The total turnover for the company is close to one billion SEK.

Company X is represented mainly in a limited geographical area in the southern parts of Sweden that stretches from the east coast to the west coast. This area is divided into four regions with separate managers responsible for each area. These region managers provide Company X with all necessary local knowledge which results in a major advantage for Company X.

Company X has gone through a big expansion in form of small firm and family business acquisitions over the last ten years, around fifty to be more precise. The concept of acquiring small firms and family businesses was established by the founder of Company X himself. This interest derived from a great belief in that family businesses possess unique attributes that would contribute to Company X both from a cultural and a profitable aspect and from the fact that Company X is a family business itself.

The strategy at the moment for Company X is to adapt the acquired companies into the organization and strive forward as one of the leading actors within their region of expertise. The founder of Company X had an entrepreneurial and optimistic way of thinking that still lives and affects the organization today.

(CEO of Company X, personal communication, 2005-04-06).

4.1.1 Intangibles that affect the value

The following factors are the ones that affect the value of a family business the most according to Company X. Depending on the characteristics of these factors, the value can be affected both in a positive and a negative way. The value of these factors contribute to the final goodwill value. There is no specific method for determining the correct goodwill value of a family business, it is more a question of estimations, intuition and negotiations between the family business and Company X.

- **Reputation**: what kind of reputation the family business has among customers, competitors, suppliers and other stakeholders is one of the deciding factors that determine the value of the family business. The research concerning the reputation is performed by the region managers. The acquired family business name is of great importance and is usually established among the customers. The idea is to get the customers to understand that it is the same business and great customer service as before, it is just another name.

- **Culture**: the culture of a company is an important factor when determining the firm value. A culture that fits well into the culture of Company X could be worth a lot.
The culture constitutes a major part of a family business and could therefore be of great value. The information about culture is gathered during meetings with owners and employees and visits at the targeted company.

- **Knowledge/Key persons:** Company X makes thorough research in finding out where in the family business the knowledge exists and who possesses it but also if there is any unique knowledge that might be difficult to manage without and if so, who possesses this kind of knowledge. Persons within the business who has a lot of core competence are called key persons and it is crucial for Company X to keep these persons within the organization since the value of the family business usually is directly connected to these persons.

- **Motivation:** To maintain the former owners’ motivation and desire to perform well is one of the main objectives Company X have after an acquisition. It is of great importance to keep the business local and maintain a family business feeling around it even though it is a part of a bigger organisation. Company X make deals with the owners of acquired businesses to keep them within the company for a certain time period. This is fulfilled by contracts. As a complement to the contract and the purchase price there are also an additional purchase price that serves as a bonus in order to maintain the work energy and motivation of the previous owners. This is based on the yearly results that the former owners can generate after the acquisition. The additional purchase price is not only an action to keep the key persons and their competence within Company X but also to prevent them from starting up a new competing business. During the period of time that the former owners stay with Company X the aim is to integrate and change the brand name into Company X.

- **Financial position:** this factor makes up a foundation for the valuation of the family business. The value is calculated with help from different valuation methods but the final price is affected when intangible assets like the reputation, culture, knowledge, customer information and motivation are taken into consideration. The intangibles can affect the price both in a positive and negative way depending on the situation for each company.

- **Customers/Market:** the size of the clientele is of great interest for Company X since this indicates the degree of dependency that the business has towards its customers. The size of the family business in relation to its market share reveals its growth potential. Other factors that are studied are how the customer care, service and relations are carried out but also the willingness of being flexible and the degree of commitment among employees and owners. The geographic location is another factor that is of great importance since this determines whether the business will fit into the existing strategy or not. Again, the region managers conduct the research.

The region managers are a main source for information concerning the market such as competitors, market shares for each Company X branch but also market shares for competitors, customers and the overall economic situation in the region. This is also the reason why the region managers are well aware of high potential companies that might be possible acquisitions within the region. Companies that have a great market share, a good reputation, a constant recurring clientele and that are well established on the market are of special interest. These managers are therefore an invaluable source of information when a family business is about to be valued before an acquisition.
The main idea is not only to acquire the family business but also to keep the founders of each company in a managerial position in order to maintain the ‘local business feeling’ and to keep the culture alive. Company X believes that by doing so an extensive ‘culture shock’ will be avoided. The founder is usually a vital part of a family business and the company would almost be worthless without him/her. This since the value of the company usually is directly tied to one or several key persons who also in most cases have all the customer relations and the core competence.

A difficult part occurs after the acquisition; to keep the manager motivated even though their business now belong to Company X. Company X applies freedom with responsibility in all their branches. The general belief is that the managers perform better if they can continue as they always have done before and do not feel like slaves under a big organisation. The family business is therefore managed as it was before with the only difference that the managers no longer have the ownership and that the name of the business is changed to Company X. The only tools of control that Company X have for their branches are the region managers and the accounts which Company X receives each month together with key ratios like for instance service hours. It is a difficult balancing between control and freedom but it is believed to pay off more in the end for all involved parts.

The succession factor is a small, but far from irrelevant factor when it comes to determining the value of a family business. For Company X it is to some extent of importance in some cases when the children of the owner are thought of as the next owner. It is not always necessary that this is seen as a positive factor. Sometimes it actually affects the value in a negative way when Company X has no belief in the inheritor of the business (CEO of Company X, personal communication, 2005-04-06).

4.1.2 Financial facts that affect the value

All of the above affects the value and the price of the family business about to be acquired. Company X has mainly used three different valuation models in order to come up with a fair value; the NUTDEL-method, valuation determined on an earnings basis with an average profit and the net worth method.

- **NUTDEL**; this model has been used in order to create an interval in which the true value lies. The foundation is an estimation of all future dividends that Company X can receive. The estimation has been done with help from historical results and development, future forecasts, relative market shares and competitors. From this estimation a best-case and a worst-case scenario has been developed and each of them are divided into two different situations. The first situation describes the value if the company will continue to exist for eternity and the second situation describes the value if the family business is to be going concern for ten years and then be liquidated. Further more, all of these four situations are calculated with three different costs of capital before and after tax. Together, this provides a picture with twelve values of the family business at three different levels of costs of capital and four different scenarios.

- **Valuation determined on an earnings basis with an estimated profit**; Company X has used the profit before tax from the previous year as an estimated profit since they consider it to be a representative number. This model also uses a best and worst case scenario that represents +/- 30% of the average profit. These three situations are calculated at five different levels of earnings multiplier in order to cover all possible future outcomes.
• **Net worth method:** This method is used to calculate the equity of the company about to be acquired. The market value of the assets is subtracted with the market value of the liabilities in order to obtain an adjusted equity. The calculation also shows the net worth adjusted to untaxed reserves and their deferred tax liabilities.

• Company X has also taken into consideration the value of the family business’ *goodwill*. The goodwill is calculated by deducting the net worth from the maximum price that Company X is willing to pay for the family business. This is calculated in order to see how much Company X can afford to pay in goodwill for the family business over the following ten years. Paying a higher price than this would not make the deal profitable.

• After the price for the family business has been determined a *P/e-ratio* has been calculated in order to show how many times Company X paid for the earnings (CEO of Company X, personal communication, 2005-04-06).

### 4.1.3 Determining the final value

After weighing together the intangibles and the calculated numbers, Company X will reach a certain point that might be the most difficult and crucial one; to determine the final price. It takes years of experience in doing acquisitions in order to gain the right intuition for making an excellent deal. This experience together with a well-developed knowledge within the specific industry and a deep understanding of family business as a phenomenon is vital to possess when closing the acquisition. No matter how well one knows how to use the right valuation methods, in the end it is the skills that one obtains from years of experience of family businesses that is of great value. The founder of Company X played an important role in this sense. He was the one who made all the acquisitions possible with his experience and deep knowledge within the industry. Since he was an entrepreneur and a founder of a family business as well himself he had a strong intuition when it came to finding small businesses with high growth and profit potential. These factors are all contributions to the success of the acquisitions strategy of Company X (CEO of Company X, personal communication, 2005-04-06).

### 4.2 Valuation of Family Business 1

This section will describe how Company X valued Family Business 1, henceforth called FB 1, before an acquisition.

This company is within the electric and telecom market and is located in the south east area of the geographic region that Company X works within. The family business had at the time of the acquisition approximately ten employees. FB 1 does not only contribute with an increase of existing knowledge, it also possesses a unique knowledge, a new line of business that Company X is missing in this particular region. FB 1 is a well established actor on its market and the potential of growing within its sector is very likely. FB 1 has a very good reputation and is well known in this district among both competitors and customers for being very service minded and customer oriented. This is a central factor in the company culture.

The owner of FB 1 was also the manager and this position was withheld when the ownership was transferred. Company X was very keen on keeping the previous owner in the organization since he held the majority of the customer relationships and was an important factor for remaining the family business culture.
Results

FB 1 had a break-even point for a profitable deal at 5.4 MSEK (see table 4.6) and that is also what the suggested price ended up to be. This implies that FB 1 had a potential that was worth investing in. In the NUTDEL calculation the interval lies between 3.5 MSEK, in a worst-case scenario, and 10.7 MSEK in a best-case scenario. The 5.4 MSEK amount lies in this interval (see table 4.1).

<table>
<thead>
<tr>
<th>Cost of capital</th>
<th>Pessimistic development</th>
<th>Optimistic development</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Before tax</td>
<td>After tax</td>
</tr>
<tr>
<td></td>
<td>The NUTDEL-value</td>
<td>The NUTDEL-value</td>
</tr>
<tr>
<td></td>
<td>for the calculations</td>
<td>for the calculations</td>
</tr>
<tr>
<td></td>
<td>year 1-10 and the</td>
<td>year 1-10 and the</td>
</tr>
<tr>
<td></td>
<td>calculations</td>
<td>liquidation value year 10</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>7.2</td>
<td>8 042</td>
</tr>
<tr>
<td>15</td>
<td>10.8</td>
<td>5 282</td>
</tr>
<tr>
<td>20</td>
<td>14.4</td>
<td>3 925</td>
</tr>
</tbody>
</table>

Table 4.1 NUTDEL-calculations for FB 1.
The estimated profit for FB 1 is 850 000 SEK, which is also the profit before tax (see table 4.4 and table 4.2). Depending on which earnings multiplier that has been used and also what scenario (+/-30% of the average profit), the interval goes from 1.5 MSEK to 6.9 MSEK.

<table>
<thead>
<tr>
<th>Earnings multiplier %</th>
<th>Lowest</th>
<th>Average</th>
<th>Highest</th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>3 718</td>
<td>5 312</td>
<td>6 906</td>
</tr>
<tr>
<td>20</td>
<td>2 975</td>
<td>4 250</td>
<td>5 525</td>
</tr>
<tr>
<td>25</td>
<td>2 380</td>
<td>3 400</td>
<td>4 420</td>
</tr>
<tr>
<td>33</td>
<td>1 803</td>
<td>2 575</td>
<td>3 348</td>
</tr>
<tr>
<td>40</td>
<td>1 487</td>
<td>2 125</td>
<td>2 762</td>
</tr>
</tbody>
</table>

Table 4.2 Valuation determined on an earnings basis with an estimated profit for FB 1.

The net worth, also known as adjusted equity, sums up to 2.14 MSEK for FB 1. As seen in the balance sheet this consists of untaxed equity, 584 000 SEK, and of taxed equity, 1 556 000 SEK. The book values are adjusted to market value, mainly regarding real estate. When deferred tax liabilities from untaxed reserves are taken into account the net worth is 1 976 000 SEK (see table 4.3 and table 4.5).

+Current assets 3 646
+ Capital assets 929
=Balance sheet total 4 575
+ Current liabilities 1 703
+ Long-term debts 732
+ Untaxed equity 584
+ Taxed Equity 1 556
= Balance sheet total 4 575

Table 4.3 Balance sheet for FB 1.

+ Operating income 11605
- Operating costs -10508
= Profit before depreciation 1097
- Depreciation -158
=Profit before financial incomes and expenses 939
+/- Financial netto -89
= Profit after financial incomes and expenses 850
+/- Extraordinary netto 0
= Profit before appropriation 850
+/- Transfers to untaxed reserves 0
= Profit before tax 850
- Tax -150
= Profit after tax 700

Table 4.4 Profit & Loss accounts for FB 1.
The net worth is calculated on the company's:

<table>
<thead>
<tr>
<th></th>
<th>Book value</th>
<th>Market value*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0</td>
<td>2140</td>
</tr>
<tr>
<td>Deferred tax liabilities from untaxed reserves (%)</td>
<td>28</td>
<td>1976</td>
</tr>
</tbody>
</table>

Table 4.5 The net worth of FB 1.

To calculate the yearly amortizations for goodwill, interest after tax on the maximum price and the incentives (10% of the profit after tax) for the former owner of FB 1 is deducted from the profit after tax; 700 000 - 308 000 - 70 000 = 322 000 SEK (see table 4.6). The amortizations will be over ten years, hence the total goodwill for FB 1 sums up to 3.22 MSEK. The net worth together with the total goodwill constitutes the maximum price that Company X is able and willing to pay for FB 1 and later also what actually was paid, 2.14 MSEK + 3.22 MSEK = 5.4 MSEK.

This price gives FB 1 a P/e-ratio of 7.7, which means that Company X paid 7.7 times the earnings for FB 1, 5 400 000 / 700 000 = 7.7

|                        | 700        |
| Profit after tax       | 700        |
| Interest after tax on purchase price (8%) | 308        |
| Incentives (10%)       | 70         |
| Amortization on goodwill | 322        |
| Goodwill space         | 3218       |

Table 4.6 Goodwill calculations for FB 1.

This section will describe how Company X valued Family Business 2, henceforth called FB 2, before an acquisition.

This family business works within the field of electric services and had at the time of the acquisition ten employees. FB 2 has a dominant position and is the market leader in its local region. FB 2 was acquired by company X because it fits strategically, a complement to the already existing network within the Company X area.

The company has its main customer focus towards industries and the public sector. FB 2 has a good reputation and is well known within its target group. This since FB 2 is very focused on its niched target group, which they have developed a close collaboration with, and are therefore highly specialized within its area of business. This fact is a main ingredient in the culture of the company and permeates the entire organization. The former owner and manager of FB 2 is to a great degree the symbol of the family business culture and the reputation and is therefore a key asset both for FB 2 and Company X. He also possesses a vital deal of the core competence in the business. This is also the main reason why the
former owner was contracted to stay in the managerial position in FB 2 even after the acquisition.

FB 2 had a break-even point for a profitable deal at 3.6 MSEK but the suggested price ended up to be 3.0 MSEK (see table 4.12). A lower offered price is generally the case in bidding situations for Company X. In the NUTDEL calculation the interval lies between 2.4 MSEK, in a worst-case scenario, and 7.5 MSEK in a best-case scenario. The 3.6 MSEK amount lies in this interval (see table 4.7).

<table>
<thead>
<tr>
<th>Year 1-10 and the calculations year 11-</th>
<th>The NUTDEL-value for the calculations</th>
<th>The NUTDEL-value for the calculations</th>
<th>The NUTDEL-value calculations for the calculations</th>
<th>The NUTDEL-value for the calculations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before tax</td>
<td>10</td>
<td>7.2</td>
<td>5 796</td>
<td>3 354</td>
</tr>
<tr>
<td>After tax</td>
<td>15</td>
<td>10.8</td>
<td>3 836</td>
<td>2 705</td>
</tr>
<tr>
<td>Cost of capital</td>
<td>20</td>
<td>14.4</td>
<td>2 865</td>
<td>2 369</td>
</tr>
</tbody>
</table>

Table 4.7 NUTDEL-calculations for FB 2.

The estimated profit for FB 2 is 670 000 SEK, which is also the profit before tax and appropriations (see table 4.10 and table 4.8). Depending on which earnings multiplier that has been used and also what scenario (+/- 30% of the average profit), the interval goes from 1.2 MSEK to 5.4 MSEK.

<table>
<thead>
<tr>
<th>Earnings multiplier %</th>
<th>Adjusted profit</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lowest</td>
<td>Average</td>
<td>Highest</td>
<td></td>
</tr>
<tr>
<td></td>
<td>469</td>
<td>670</td>
<td>1 950</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>2 931</td>
<td>4 187</td>
<td>5 443</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>2 345</td>
<td>3 350</td>
<td>4 355</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>1 876</td>
<td>2 680</td>
<td>3 484</td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>1 421</td>
<td>2 030</td>
<td>2 639</td>
<td></td>
</tr>
<tr>
<td>40</td>
<td>1 172</td>
<td>1 675</td>
<td>2 177</td>
<td></td>
</tr>
</tbody>
</table>

Table 4.8 Valuation determined on an earnings basis with an estimated profit for FB 2.

The net worth, also known as adjusted equity, sums up to 834 000 SEK for FB 2. As seen in the balance sheet this consists of untaxed equity, 96 000 SEK, and of taxed equity, 738 000 SEK. The book values are adjusted to market value, mainly regarding real estate. When deferred tax liabilities from untaxed reserves are taken into account the net worth is 807 000 SEK (see table 4.9 and table 4.11).
+ Current assets 2 151
+ Capital assets 5 651
= Balance sheet total 7 802
+ Current liabilities 1 257
+ Long-term debts 5 711
+ Untaxed equity 96
+ Taxed Equity 738
= Balance sheet total 7 802

Table 4.9 Balance sheet for FB 2.

+ Operating income 11706
- Operating costs -10432
= Profit before depreciation 1274
- Depreciation -146
= Profit before financial incomes and expenses 1128
+/- Financial netto -458
= Profit after financial incomes and expenses 670
+/- Extraordinary netto 0
= Profit before appropriation 670
+/- Transfers to untaxed reserves -72
= Profit before tax 598
- Tax -62
= Profit after tax 536

Table 4.10 Profit & Loss accounts for FB 2.

The net worth is calculated on the company’s:

<table>
<thead>
<tr>
<th>Book value</th>
<th>Market value*</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>834</td>
</tr>
<tr>
<td>28</td>
<td>807</td>
</tr>
</tbody>
</table>

Deferred tax liabilities from untaxed reserves (%)

<table>
<thead>
<tr>
<th></th>
<th>0</th>
<th>28</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book value</td>
<td>834</td>
<td>807</td>
</tr>
<tr>
<td>Market value*</td>
<td>834</td>
<td></td>
</tr>
</tbody>
</table>

* Adjusted equity, real estate

Table 4.11 The net worth of FB 2.

To calculate the yearly amortizations for goodwill, interest after tax on the maximum price and the incentives (10% of the profit after tax) for the former owner of FB 2 is deducted from the profit after tax; 536 000 - 207 000 - 54 000 = 275 000 SEK (see table 4.12). The amortizations will be over ten years, hence the total goodwill for FB 2 sums up to 2.75 MSEK. The net worth together with the total goodwill constitutes the maximum price that Company X is able and willing to pay for FB 2, 834 000 SEK + 2 750 000 SEK ≈ 3.6 MSEK. The actual paid price though, ended up to be 3.0 MSEK. Hence, this will result in a decreased total goodwill of 2 166 000 SEK; 3 000 000 SEK – 834 000 SEK.

This price gives FB 2 a P/e-ratio of 5.6, which means that Company X paid 5.6 times the earnings for FB 2, 3 000 000 / 536 000 = 5.6.
Results

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit after tax</td>
<td>536</td>
</tr>
<tr>
<td>Interest after tax on purchase price (8%)</td>
<td>207</td>
</tr>
<tr>
<td>Incentive (10%)</td>
<td>54</td>
</tr>
<tr>
<td>Amortization on goodwill</td>
<td>275</td>
</tr>
<tr>
<td>Goodwill space</td>
<td>2750</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Break point for purchase price</th>
<th>3.6 MSEK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final purchase price</td>
<td>3.0 MSEK</td>
</tr>
</tbody>
</table>

Table 4.12 Goodwill calculations for FB 2.
(CEO of Company X, personal communication, 2005-04-06).

4.4 Valuation of Family Business 3

This section will describe how Company X valued Family Business 3, henceforth called FB 3, before an acquisition.

FB 3 is a company within the electric market and is situated in the northeast parts of the Company X zone. It is considered a geographic complement to the region. FB 3 had 27 employees at the time of the acquisition and has a solid customer base where 80% are continuously returning customers. Therefore Company X perceives FB 3 as a very reliable and stable family business.

FB 3 was before the acquisition owned and managed by four family members. The management and its personnel is considered very competent by Company X. FB 3 is a very well established brand name and a company with a strong local reputation due to the great competence of the staff and also the well-managed customer relations and service. The family business culture in FB 3 is characterized by the strive to withhold the high customer retention rate, the owners, the knowledge and the competence. The competence of FB 3 is a perfect fit into Company X’s network and organisation. The four previous owners are still managing and running the company as they used to do and are considered key persons for FB 3. They were tied up by an additional purchase price for five years in order to maintain the culture and keep the knowledge and customers within Company X.

FB 3 had a break-even point for a profitable deal at 9.5 MSEK but the suggested price ended up to be 8.0 MSEK (see table 4.18). In the NUTDEL calculation the interval lies between 6.2 MSEK, in a worst-case scenario, and 18.8 MSEK in a best-case scenario. The 9.5 MSEK amount lies in this interval (see table 4.13).
### Results

#### Table 4.13 NUTDEL-calculations for FB 3.

The estimated profit for FB 3 is 1.5 MSEK, which is also the profit before tax (see table 4.16 and table 4.14). Depending on which earnings multiplier that has been used and also what scenario (+/- 30% of the average profit), the interval goes from 2.6 MSEK to 12.2 MSEK.

#### Table 4.14 Valuation determined on an earnings basis with an estimated profit for FB 3.

The net worth, also known as adjusted equity, sums up to approximately 4 012 000 SEK for FB 3. As seen in the balance sheet this consists of untaxed equity, 1 051 000 SEK, and of taxed equity, 2 961 000 SEK. The book values are adjusted to market value, mainly regarding real estate. When deferred tax liabilities from untaxed reserves are taken into account the net worth is 3 718 000 SEK (see table 4.15 and table 4.17).

#### Table 4.15 Balance sheet for FB 3.

<table>
<thead>
<tr>
<th>Adjusted profit</th>
<th>Lowest</th>
<th>Average</th>
<th>Highest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings multiplier %</td>
<td>1 050</td>
<td>1 500</td>
<td>1 950</td>
</tr>
<tr>
<td>16</td>
<td>6 562</td>
<td>9 375</td>
<td>12 187</td>
</tr>
<tr>
<td>20</td>
<td>5 250</td>
<td>7 500</td>
<td>9 750</td>
</tr>
<tr>
<td>25</td>
<td>4 200</td>
<td>6 000</td>
<td>7 800</td>
</tr>
<tr>
<td>33</td>
<td>3 181</td>
<td>4 545</td>
<td>5 909</td>
</tr>
<tr>
<td>40</td>
<td>2 625</td>
<td>3 750</td>
<td>4 875</td>
</tr>
</tbody>
</table>

| +Current assets | 4 516 |
| + Capital assets | 1 639 |
| =Balance sheet total | 6 155 |
| + Current liabilities | 2 143 |
| + Long-term debts | 0 |
| + Untaxed equity | 1 051 |
| + Taxed Equity | 2 961 |
| = Balance sheet total | 6 155 |
Results

+ Operating income 17283
- Operating costs -15687
= Profit before depreciation 1596
- Depreciation -107
=Profit before financial incomes and expenses 1489
+/- Financial netto 11
= Profit after financial incomes and expenses 1500
+/- Extraordinary netto 0
= Profit before appropriation 1500
+/- Transfers to untaxed reserves 0
= Profit before tax 1500
- Tax -420
= Profit after tax 1080

Table 4.16 Profit & Loss accounts for FB 3.

The net worth is calculated on the company's:

| Book value | 4012 | 28 |
| Market value* | 4012 | 3718 |

Deferred tax liabilities from untaxed reserves (%)

Table 4.17 The net worth of FB 3.

To calculate the yearly amortizations for goodwill, interest after tax on the maximum price and the incentives (10% of the profit after tax) for the former owner of FB 3 is deducted from the profit after tax; 1 080 000 - 421 000 - 108 000 = 551 000 SEK (see table 4.18). The amortizations will be over ten years, hence the total goodwill for FB 3 sums up to 5.5 MSEK. The net worth together with the total goodwill constitutes the maximum price that Company X is able and willing to pay for FB 3, 4 012 000 SEK + 5 513 000 SEK = 9.5 MSEK. The actual paid price though, ended up to be 8.0 MSEK. Hence, this will result in a decreased total goodwill of 3 988 000 SEK; 8 000 000 SEK – 4 012 000 SEK.

This price gives FB 3 a P/e-ratio of 7.4, which means that Company X paid 7.4 times the earnings for FB 3, 8 000 000 / 1 080 000 = 7.4.

| Goodwill space | 5513 |
| Break point for purchase price | 9.5 MSEK |
| Final purchase price | 8.0 MSEK |

Table 4.18 Goodwill calculations for FB 3.

(CEO of Company X, personal communication, 2005-04-06).
5 Analysis

This chapter intends to analyse the empirical findings with relevant theories. It will start with presenting the intangibles that affect the value of a family business. It is further analysed which valuation methods that have been used in Company X when a family business is about to be acquired. The chapter ends with an analysis of the three cases that have been studied and finally a comparison between the three cases.

5.1 Intangibles that affect the value

- The reputation of a family business is an important factor for Company X both to discover an opportunity of acquiring a company and as a part of the valuation of it. According to us, the region managers are Company X’s eyes and ears on the market; they gain important market information. The region managers are very important when searching the market for prospects and without them Company X would not have the deep knowledge and feeling of the market they act upon. A good reputation could mean a higher value of a company but also the opposite around if the reputation is negative. It is most likely accurate because reputation entails good customer relationships, satisfied and returning customers and according to Stainer (2002) these social acts influence the financial results in a positive manner. Company X has a great confidence in that family businesses perform better than non-family businesses. It is possible that the belief in family businesses has it roots in that Company X is a family business itself. This could explain why they prefer to acquire family businesses. Conducted research within the field supports their belief. According to Ward and Aronoff (1991), family businesses are very concerned about their reputation because it is not only the name of the business that they represent but also their family name. They further argue that customers tend to prefer to do business with family businesses because of this fact and that it creates long-term relationships and trust, which in the end leads to a good reputation. Leach and Bogod (1999) states that family businesses are more customer oriented than non-family businesses. It is most likely that these factors help to build up a reputation that is valuable and often unique features for family businesses. The presented facts show that the reputation is stronger and more crucial in a family business than in a non-family business because of the fact that the reputation of the family is also at the risk. It also illustrates that reputation has an effect on the value of a family business, negative or positive depending on how the reputation is perceived.

- Company X uses culture as a fact for increased value of a family business. The reasons they mention this are twofold. The first is that family businesses have similar entrepreneurial family business culture as Company X and are therefore easy to adapt into their organisation. The second reason is that the culture in a family business characterizes the company to a great extent and creates a unique entity, hence creates a competitive advantage. This applies well with the study presented by Denison et al. (2004) about how family businesses have cultural advantages compared to non-family businesses. The study measured levels of involvement, adaptability, mission and consistency and showed that family businesses are superior compared to non-family businesses in all these attributes. The authors believe that the reason for this is that founders of family businesses have entrepreneurial values that are transferred into the business and its employees. The culture becomes a competitive advantage because it is hard to copy and create without an entrepreneurial spirit, something that non-family businesses often do not possess. It is obvi-
ous that culture is impossible to measure and the valuation of the culture is completely dependent on the experience and intuition of the acquirer. Moreover, it is clear that Company X has a great understanding in the cultural values of family businesses and it is of their greatest interest to acquire businesses with similar culture in order to maintain and protect the existing family business culture within the entire Company X group. The fact that after an acquisition the former owner still maintain within a managerial position shows that Company X is eager to avoid cultural shocks. This could have been the case if Company X would have tried to influence the culture of the acquired business. Since Company X acquired around fifty family businesses within a short period of time it is of even greater importance to keep the added value that the culture of the acquired companies actually create.

- **Knowledge** and sometimes a unique knowledge or competence adds value to a company according to Company X. Their ambition is to be market leaders and this demands a high degree of knowledge within its field of business. A traditional way of doing things is common within family businesses but it is not always an advantage. Leach and Bogod (1999) discuss how traditional ways of doing things could lead into rigidity, a state that prevents the business from looking with open eyes and creates an unwillingness to adapt to changes even if it would be of great benefit. These facts matters when Company X values a business. Knowledge can very well be a competitive advantage due to the fact that this knowledge is easier to protect and keep within the company walls of a family business than within a non-family business. Greater loyalty among employees is the explanation for this according to Donnelley (1988). Company X works with services and it is obvious that knowledge is a crucial fact for success. A danger connected between knowledge and family businesses is that one or a few key persons often possess the knowledge. This is why many first generation family businesses do not survive the first generation shift (Lansberg, 1988); the knowledge disappears with the founder. The knowledge in a family business is therefore only an advantage if treated right and taken care off properly. A basic motive for Company X, when acquiring businesses, is to get access to knowledge and continue using it within their organisation. Company X is therefore very dependent on keeping the former owner of a family business after an acquisition. The fact that Company X always tries to identify who possesses the most crucial and valuable knowledge in order to estimate a value is vital since these persons are closely connected to the value of the family business. However, preferably this knowledge should not only be detected but also spread throughout the company in order to keep the value that this knowledge creates within the walls of Company X and also to prevent that the knowledge disappear if the key person disappears. This would lead to an increased security for the customers but also for the entire Company X group. If the knowledge is spread, so is the value.

- The maintaining of knowledge/key persons involves how to keep up the motivation of the previous owner when he/she no longer has possession of the business. If the motivation decreases, much of the previous energy and passion surrounding a family business is lost and this makes the motivation a fatal problem if not mastered correctly. Without motivation the previous owner will either not work as efficiently as before or leave the business. Motivation is often created in a family business since the fear of unemployment triggers survival instincts (Littunen, 2003). A major interest for Company X is to keep the local and family business feeling after an acquisition to keep the unique values that it contains. Littunen (2003) states that uncertainty for the future creates not only motivation but also commitment. Ac-
cording to Gallo et al. (2004) and Hoy and Verser (1994), commitment is one of the hallmarks and a major reason to why family businesses are different compared to non-family businesses and that is a fact that Company X definitely wants to keep. Company X uses contracts, bonuses and additional purchase prices to try and maintain this atmosphere. However, one of the main incentives is after all the fact that the previous owner has the possibility to keep the business running in the spirit as it always has been. It is obvious that when determining a value for a family business about to be acquired motivation does play a certain role. In order to secure the motivation after the acquisition Company X uses an additional purchase price.

- The financial position is the basis for determining a value of a family business. This will be analyzed in the following section.

- When Company X acquires a family business they also acquire most of its clientele. It is therefore important that the customer relationships are good and strong, otherwise there will not be much growth potential and that will affect the value of the firm. The research within this field shows that family businesses are more customer oriented and service minded than non-family businesses (Gallo et al., 2004; Ward & Aronoff, 1991). Another factor, closely related to service, that helps to create positive customer relationships is flexibility. Family businesses are very flexible in work, time and money issues (Leach & Bogod, 1999) and it is most likely that if the family business feeling can be kept so can the flexibility, otherwise it could be lost and the value of the company might be affected. As a result of good customer care the family business will experience a high rate of customer retention. This will in most cases affect the value in a positive way. Family businesses have in general more loyal customers because they are more service minded and are trust worthier than non-family businesses (Ward & Aronoff, 1991). This issue is also supported when valuing the family business according to the NUTDEL-model. The importance of the clientele and market should not be underestimated since it is a vital fact when weighing the values of a family business together.

5.2 Financial facts that affect the value

Company X uses several valuation methods as tools when estimating a value of a family business. The economic calculations constitute a foundation for the valuation and then non-economic intangibles are taken into account when calculating the final price. To be able to obtain a fair value it is recommended to use several valuation methods (Yegge, 2002). This since different standpoints can result in different values of a company (Hägg, 1991; Hult, 1998). The value of a family business is in many cases directly tied to the owner since he or she usually possesses all the customer relations and other contacts that are crucial for the continued existence of the business. This is an important fact to take into consideration in the valuation of the business (Nilsson et al., 2002). Wright (1995) also stresses the importance of finding out assets and liabilities that do not appear in balance sheets since these usually affect the value noticeably. Company X performs extensive research before an acquisition of a family business in order to estimate the value of the intangible assets like goodwill in shape of reputation, culture, key persons who possesses unique knowledge and crucial contacts. This research is necessary since these intangible assets do not appear in the balance sheet and might affect the value of the family business in a positive or a negative direction.
Hult (1998) argues that the **NUTDEL-method** can be applied on all different kinds of companies since it takes the human resource’s capability of creating value and contribute to the result into consideration. Company X exclusively buys small service companies in which the employees are the most important assets and this is also why we claim that it is a good idea to apply the NUTDEL-method on these companies. Otherwise the value added that the employees create and posses in knowledge might not be taken into consideration in a valuation. The method is based on assumptions and forecasts about the future, which creates different scenarios concerning future profits and dividends. The fair value can be found in an interval that is calculated from the scenarios and forecasts.

The NUTDEL-method is divided into three parts; analysis, forecast and calculation. In the **analysis** phase the company’s historical data, balance sheets and profit and loss accounts, together with its present situation make up the basis for the estimation of what the future might bring. Company X makes research about the family business before an acquisition with guidance from historical balance sheets and profit and loss accounts. The region managers in Company X also make an analysis of the family business’ market share, competitors and customers but consideration is also taken about where in a business cycle the family business is at the moment and other intangible factors that are specific for family businesses. Another important factor for Company X in this phase is to estimate the importance of key persons and owners. These facts are then analyzed. In the **forecast** phase the information gathered in the analysis phase becomes the foundation for forecasting the future. The forecasts are then divided into scenarios that represent pessimistic, normal and optimistic outcomes to minimize the risk. Company X uses a best case and a worse case scenario which each is divided into situations that describe the value of the company if a) the family business will continue to exist for eternity and b) the family business will be liquidated after ten years. The **calculation** phase consists of a calculation of the value of the family business. Company X calculates an interval with twelve values at three levels of cost of capital. The highest value represents the value of the family business at a best-case scenario and the highest possible rate of return. The lowest presented value represents the value of the business at a worse case scenario and the lowest possible rate of return. Somewhere in the interval a fair value is expected to lie.

If used right and if conducted from thorough research that results in high quality information, naturally this method becomes a strong tool for Company X when valuing a small family business in the service sector. This since the method takes the value added into consideration. The difficulty is to make up forecasts that are reliable and to take all possible information into account. It is possible that Company X has not done this in a proper way and if so, the credibility of the method is not so high. However, it is most likely that Company X conducts thoroughly research on all their possible acquisitions. This is based on the fact that they possess a unique knowledge about the market and all actors on it since Company X itself is a major actor on the same market. It is also of great importance that the region managers gain deep insight in the market and are perfectly aware of competitors, market shares and customers, since they are the main source for this kind of information.

**Valuation determined on an earnings basis with an estimated profit;** Company X has probably used valuation determined on an earnings basis with an estimated profit in or-
der to see how sensitive the company is towards the change in profit. Company X claims that the estimated profit is a representative number while the theory, for example by Nilsson et al (2002), claims that an estimation of the long-term value in terms of a persistent profit is representative as well. Since the persistent profit is based on estimations as well they basically represent the same facts. Evidently both theories work well for small, stable businesses and they are both reliable because of the fact that they take different rates of required returns into consideration. However, Company X has further developed this model in the case with the estimated profit and presents a best and a worst-case scenario. Apparently, this provides a better picture on how sensitive the company is regarding fluctuations in the annual profit.

- Company X uses the *net worth model* as a basis for the valuation but also as a complement to the other applied methods; NUTDEL and valuation determined on an earnings basis with an estimated profit. This is also what Nilsson et al. (2002) recommends. They further argue that using the net worth model solely would mean estimating the equity and only work as an exchange of money between buyer and seller. Therefore it is best applied when constituting a foundation that represents the lowest possible value of a business. This is also the case when Company X values a family business.

According to the method the equity of a business should be adjusted for the real value of assets and liabilities, and the deferred tax liabilities, which derive from the untaxed reserves may also be considered (Nilsson et al., 2002). The most important adjustment that Company X must consider in each valuation is the market value of the real estate, which usually differs from the book value. Company X calculates two net worth values; one without adjustment of the deferred tax liabilities and one with the adjustment of the deferred tax liabilities. This is done in order to show the real equity when tax is taken into account.

Nilsson et al. (2002) also mention that the net worth method’s main disadvantage is that it does not consider intangible assets or the future creation of value. This is the reason why Company X uses the net worth method as a complement and a basis for other valuation methods. Effort is put into estimating a goodwill value, which together with the net worth composes the fair value. Apparently, the net worth model constitutes a good basis for company valuation since it reflects what the equity actually is worth and it might be difficult to manage a valuation process without it. After this is done, a fuller valuation should be done in order to estimate what the value creation and intangible assets are worth.

- **Goodwill:** Estimating the value of a company’s goodwill is a critical issue in an acquisition process and probably of even greater importance for family businesses. Frykman and Tolleryd (2003) emphasizes on the fact that goodwill is what exceeds the assets in the balance sheet from the final price. It is of great importance to come up with a fair goodwill value, but this can also be contradictory when the acquiring company wishes to pay as little goodwill as possible in order not to have their result affected negatively. Goodwill is the only factor that the company pays for that is negotiable and a subject for estimation. Company X has made this very comprehensible by using a calculation in order to see how much they are willing to pay as a maximum price and then deducting the assets in the balance sheet. The actual value for the family business that was determined can be seen very clearly in
the three cases regarding how much goodwill that was paid in the end. It differs a lot from case to case how close the final price is compared to the maximum price established. Depending on how the intangibles were perceived by Company X in the different family businesses the goodwill value differs as well.

- *Multiples:* The P/E-ratio is the only trading multiple that Company X has used during the valuation process. This could be explained by the fact that this multiple is relatively easy to use and that it is well suited on a small firm with a stable growth. It is also a good multiple to use in this case since the family businesses that have been valued are close to identical. However, it would have been preferred to see several multiples in order to get a broader view of the determined value and how it reflects the profit and loss accounts, both before and after depreciation and amortization.

Transaction multiples were never mentioned whatsoever, neither in the interview nor in the calculations. Still, it is most likely that these are greatly used within Company X, possibly unconsciously, considering the fact that they have acquired a large number of small family businesses within the exact same industry. The concept of transaction multiples is to compare previously performed acquisitions of companies similar in size and industry. This experience, family business knowledge, industry knowledge and gained intuition create an enormous advantage for them when it comes to determining the true value. It could be the case that Company X is not aware of the concept and therefore never had the knowledge in how to take advantage of this properly. If so, it should be of great interest for Company X to enlighten this fact and take advantage of it. Since they possess large quantities of sensitive information regarding family businesses similar to the ones they intend to acquire, setting up a guideline for such transaction multiples would be a suggestion. If doing so, the knowledge could easier be spread around to other staff involved in the acquisition process and make more people capable of completing a successful merger or acquisition.

### 5.3 Analysis of Family Business 1

FB 1 fulfils the definition of a family business that is used in this thesis. This since ownership and management are held by the same person and that both Company X and FB 1 perceives it to be a family business. In this case the maximum price that Company X was willing to pay was actually the final price. This is an extremely unusual situation and it shows that Company X was very eager to buy FB 1 and had a strong belief in the future of this business. The main reasons for valuing the goodwill of FB 1 so high are the following:

- *Knowledge and unique knowledge:* this company possessed knowledge that Company X did not. It was a perfect strategic fit and contributed to a development of the existing business.

- *Well established on the market:* this company had a loyal and stable clientele.

---

6 Information gathered from lectures held by JP Morgan at the European Business School, Germany, 2004.

7 Information gathered from lectures held by JP Morgan at the European Business School, Germany, 2004.
Analysis

- **Growth potential;** this is one of the factors that Company X valued highly in this acquisition because of the possibility for FB1 to grow and add value in Company X was very likely.

- **Good reputation;** FB 1 had an excellent reputation and this was also a crucial factor for creating value for Company X.

- **Service minded and customer oriented culture;** this was a spirit within the company and FB 1’s way of doing things appealed to Company X since this fit well into the culture of Company X.

All of the factors above were valued to 3.2 MSEK and together with the net worth the final price added up to be 5.4 MSEK. In most cases Company X tries to pay as little as possible for the goodwill and it is not very common for them to pay the maximum price but in this case they considered it to be of great value.

Even though the maximum price was paid, Company X probably made a profitable deal because of the fact that the goodwill constitutes 3.8 estimated annual profits and this seems like a profitable investment since if the future annual profits will turn out to be as they were forecasted to be the investment will pay off in quite a short period of time.

5.4 Analysis of Family Business 2

FB 2 is considered to be a family business according to the definition determined. It is owned and managed by the same person and is perceived as a family business. In this case 83% of the maximum price was paid. The reason for not paying the maximum price was that the growth potential probably was limited. However, the goodwill was valued quite high and these are the factors that affected it:

- **Dominant position/Market leader;** the fact that FB 2 was market leading played a big role when determining the value of the goodwill.

- **Complement;** FB 2 performed a service that Company X wanted to implement in their existing service portfolio and was therefore of great value.

- **Good reputation;** FB 2 possessed a good reputation within its area and was also a factor that was taken into consideration when valuing the goodwill.

- **Niche target group, new customers to Company X;** FB 2 had a niched target group and these customers were new to Company X and therefore of big interest.

- **The owner affects the culture in a positive way;** the previous owner of FB 2 was one of the biggest artefacts, which constituted a big part of the family business culture. His leadership style was of great value according to Company X.

After weighing these factors together Company X came up with a goodwill value of 2.75 MSEK which together with the net worth resulted in a break-even of 3.6 MSEK. However, the final price was set to 3.0 MSEK, thus the goodwill value was negotiated down to 2.15 MSEK. The experience and intuition of Company X revealed that the goodwill was not worth 2.75 MSEK and this would not represent a fair value.
The final value of the goodwill (2.15 MSEK) was equal to 3.2 estimated annual profits. If Company X would have paid the maximum price the goodwill would have constituted 4.1 estimated annual profits.

Acquiring this family business was probably strategically correct because of the service complement it constituted but since the possibility of growing was more limited in this case the goodwill was negotiated down to a lower level.

5.5 Analysis of Family Business 3

The chosen definition of a family business used in this thesis suits well on FB 3. Ownership and management are held by four people from the same family. Company X paid 84% of the maximum price for FB 3. The reason for not paying the maximum price could possibly be the fact that the turnover per employee is low. However, the goodwill was valued quite highly anyways and the reasons for this are the following:

- **Geographic complement;** this factor was crucial for the goodwill value since it constituted an important geographic location in the Company X zone.
- **Solid customer base, high retention rate;** the fact that 80% of the customers return to FB 3 is also one of the main reasons when the goodwill was valued. This together with the geographical complement composes a totally new clientele, which is of great value.
- **Reliable and stable;** Company X got the impression of a reliable and stable company and that is a fact that Company X puts great value in.
- **Core competence and knowledge;** FB 3 possesses core competence and knowledge to a great extent and the knowledge was spread throughout the company, which contributed to the goodwill value.
- **Established brand name and strong local reputation;** FB 3 had a long history and was well-known within this area. The fact that the reputation was strong was seen as a great advantage.

All of the factors described above resulted in an estimated goodwill value of maximum 5.5 MSEK, which together with the net worth gave a maximum price of 9.5 MSEK. Yet, the final value of the goodwill was set to approximately 4 MSEK and the final price ended up to be 8 MSEK.

It is most likely that Company X made a profitable deal because of the fact that the goodwill paid constitutes only 2.7 estimated annual profits. Consequently, the investment will, if the estimations are correct, pay off in a short period of time. If the maximum price would have been paid, the goodwill would have equalled 3.7 estimated annual profits.

5.6 Comparison of the three cases

When analyzing the three cases, some similarities and dissimilarities appear. It is easier to compare FB 1 and FB 2 since they are of the same size. FB 1 and FB 2 have the same number of employees and approximately the same turnover. However, FB 1 has more than twice as big net worth as FB 2, FB 1 has a higher estimated profit and the goodwill is valued much higher in FB 1. This is probably some of the reasons why Company X paid the
maximum price for FB 1 but only 83% of the maximum price for FB 2. The reasons for a higher goodwill in FB 1 are due to the fact that the future looks brighter for FB 1. Both companies have a good reputation connected to the family, core competence and a strong family business culture but Company X obviously saw a bigger potential in FB 1, probably based on intuition and the knowledge within the field of family businesses. Moreover, it is most likely that the reason why Company X would not pay the maximum price for FB 3 is due to the fact that an additional purchase price was a part of the deal. By doing this Company X was assured that the family was still tied to the existing business. This is a sign of uncertainty towards FB 3 and this is probably why the goodwill value was negotiated to a lower number and why the final price that was paid was lower.
6 Conclusion

In this chapter the thesis is concluded. A description of how Company X values family businesses is presented.

When determining a value of a family business several factors have to be taken into consideration. This since family businesses differs in many ways from non-family businesses. This fact is also supported by relevant theories. Thus, this led us to the question of how an acquiring company values a family business and further to the following purpose;

To describe how valuation of family businesses is done. This will be carried out from the perspective of an acquiring company in order to increase the understanding within this area.

When Company X is about to acquire a family business the following significant factors are taken into consideration and weighed together in order to estimate a total value of the family business; reputation, culture, knowledge/key persons, motivation, financial position and customers/market. Determining a fair value of these factors can be very difficult. Theories support that the intangibles described above are stronger in family businesses than in non-family businesses. Hence, these intangibles are also harder to value in a family business than they are in a non-family business. Depending on if these attributes are considered to be profitable or unprofitable the value will be affected in a positive or a negative way.

Even though the intangibles presented above are crucial when determining the value, Company X uses several valuation methods in order to obtain a foundation regarding the value of the family business. This foundation is built up by using the following valuation methods; NUTDEL-method, valuation determined on an earnings basis with an estimated profit, the net worth method, a goodwill calculation and a P/e-ratio. There are reasons to believe that transaction multiples is to some extent used in Company X, due to the fact that the founder had a superior knowledge about family business since he had himself built up the Company X group.

Many of the valuation methods are to some extent insufficient when it comes to determining a fair value of a family business. Some of the models are of no use when they stand alone, but together they contribute to creating an interval where the true and fair value of the family business lies.

In addition to the valuation procedure described above Company X possesses the invaluable skills necessary when it comes to determining a value of a family business; family business knowledge and experience, acquisition experience, industry knowledge and intuition. Company X gained these skills from years of acquiring family businesses of the same size from the same industry.

In conclusion, it does not really matter how well one knows how to determine a value with help from different valuation methods. It has become obvious that the crucial skills to possess are experience, industry knowledge, intuition and most of all family business knowledge and experience when determining a fair value of a family business.

The conclusion of this thesis can only agree with JP Morgan Investment Bank that valuation of companies really is more an art than it is a science and this goes well with family businesses as well.
7 Discussion

This chapter discusses the outcome of the study conducted.

7.1 Evaluation and Critique of the Study
The result of this study is derived from a relatively small number of cases. Due to this fact, the possibility of making generalizations was limited. However, this was not the purpose of the study. Instead, petite generalizations was made regarding small family businesses in the service sector. Although, if the study would have included a comparison between valuation of family businesses and non-family businesses the outcome might have been different and the picture might have been even broader. It would also have been interesting to conduct this study from a quantitative approach in which several acquiring companies would have been used. However, this would have meant that each acquisition would have been more superficially studied and insight might not have been gained in the details that are crucial when valuing a family business.

7.2 Final Remarks
It is suggested that Company X should take a closer look at the intangibles and make this somewhat a more systematic routine. Consequently, this could lead to a deeper understanding and a helpful guidance regarding the value of these assets. Moreover, a routine like this would also be appropriate for the use of transaction multiples. If a guideline for these areas would be conducted the awareness would increase among the employees within the Company X group and the unique knowledge would be spread and would not only be held by a few key persons. This might also be useful for future mergers or acquisitions.

7.3 Suggestions for Further Studies
During the work with this thesis different ideas concerning other research issues arised. After the interview with Company X we gained deeper insight in their problems regarding the integration of the acquired family businesses into the Company X group. It takes both time and money to develop a well functioning integration strategy and this issue could be interesting to examine further.

Another subject matter that arose during the study was the issue regarding the synergie effects. It could be of great interest to study the synergy effects that occurs when a merger or acquisition is closed.

Finally, the motivation factor could be an interesting factor to take a closer look at. It could be of great interest to examine how Company X or any other family business acquiring company deals with keeping up the motivation of the previous owners after the takeover is completed.
References


References


