Introduction to Farm Business Valuation

This resource is meant to be an informational guide to assist farmers who are considering selling their business. California FarmLink does not provide business valuation services.

There are many well-established ways to determine the value of the land where your farm or ranch operates, but it is much more difficult to establish a fair value for the business itself. There is no perfect formula that will give you the right answer. However, there are tools you can use to assist your valuation decision.

1. Organize your business finances and paperwork.

A buyer will want to see the following:

- Federal Income Tax Returns for the past three years that show your business's income and expenses.
- Information on your owner draws and/or salary history.
- Balance Sheet (see detail below) and Income Statement for the past three years.
- Detail about what the business income includes and verification of these items.
  - Examples include contracts with a specific sales channel or leases for business operations.
  - You will need to confirm that these items can actually be transferred to a new business owner. If you are planning to pass a lease to a new business owner, it's critical that the agreement allows for transfer, and the landowner is informed and in agreement. Similarly, if the business relies on sales at a particular farmers market, is it feasible for the new owner to continue selling at that market?

2. Review your Balance Sheet in detail.

- A balance sheet shows the assets and liabilities of a business.
  - If you do not already have a current balance sheet, you should create one; it will facilitate many of the actions you will need to take to sell the business and to file your final tax return for the business.
- Review the assets section of your balance sheet in detail.
  - Assets should be listed on your balance sheet at their historic cost (what you paid for it) less accumulated depreciation (the amount of the purchase price expensed as depreciation since you bought it).
  - A balance sheet should include permanent crops (trees and vines) and breeding livestock but does not normally list growing crops or livestock held for sale. It should also include product inventory.
  - If all of your assets are not listed on your balance sheet you may need to work with an accountant to correct your balance sheet.
- Review the liabilities section of your balance sheet, and run detailed reports to look at accounts payable.
  - Are you planning to include these liabilities in the sale of the business? Or are you planning to pay them with proceeds from the sale of the business? Does the business need to sell for a certain amount so that you can pay existing liabilities?
  - If you plan to include liabilities with the sale, such that the new owner will become responsible for paying those liabilities, make a detailed list of the liabilities you want to include.
- See more information on Balance Sheet specifics & valuation tools below.

3. Determine an approximate value for your business.

For a formal valuation, you will need to hire a valuation specialist. The valuation specialist is trained to use a variety of methods to value your business and then determine the best estimate of value based on their analysis of all the facts. You can do an informal analysis of your business value to get a sense of the range of values you might expect from a formal evaluation or to determine a reasonable starting place for a negotiation.

THERE ARE TWO STANDARD APPROACHES:

- **Income based** — A general indicator of an income-based valuation is annual net cash flow multiplied by 3.5 or the number of years the purchaser will need to recoup their investment.
  - Net cash flow is all the money coming into your farm minus all the money going out of your farm in one year.
  - The advantage of this method is that it represents the idea that the individual purchasing your business should be able to recoup their investment in 3.5 years. Remember this is for the valuation of the business, not the land on which the business operates!
  - A disadvantage of this method is that the purchaser might not be able to sustain the same cash flows as you. Will they have access to the same land, same market channels, and existing crops? If not, then it is not realistic to assume they will be able to replicate the current conditions for your business, so a lower value may be appropriate.
- **Asset based** — This method is the sum of the fair market value of all the physical assets of the business.
  - Fair market value is the price in a willing exchange between an unrelated buyer and seller.
  - You can estimate fair market value by looking at prices for farm equipment at local farm auctions.
  - The advantage of this method is that it is objective and realistic and lenders will likely use this method to determine the amount of the purchase price they will finance.
  - The disadvantage of this method is that it does not consider any of the intangible value of the business. An asset sale is not a sale of the business; it is a sale of the assets of the business and usually means that the business itself ends.

4. Other methods.

A market-based method determines the value of the business based on the purchases and sales of comparable companies within the same industry. This is exceptionally difficult for most farm businesses, given the lack of information available in the industry.

Another helpful approach is to think about how much a potential buyer could qualify for to get a loan. Generally, lenders will not lend on intangible assets or goodwill, like market relationships or your business name. Even if a buyer agrees that your CSA email list is worth a certain amount, this is relationship-based and not tangible collateral. FarmLink can generally only provide loans secured by tangible collateral, including crops, livestock, equipment, infrastructure, and land.

5. Additional Considerations.

CREATING A "PRO FORMA" BALANCE SHEET

In addition to your balance sheet (at historic cost) you may want to create a "pro forma" balance sheet listing all business assets at their estimated current fair market value, and listing any liabilities you intend to sell with the business.

A regular balance sheet shows assets and liabilities at their historic cost less depreciation taken. A pro forma balance sheet shows assets and liabilities at the current fair market value. It is essentially the balance sheet the purchaser is buying if the purchaser is buying the whole business. Below are some things to keep in mind when creating your balance sheet and pro forma balance sheet.

Valuing Intangible Assets or Goodwill on the Pro Forma Balance Sheet

- The brand name, logo, website, and reputation of the farm are also valuable assets you may consider selling with the business. These assets are called "intangible assets" and when sold are referred to as "goodwill." Intangible assets are usually not recorded on the historic balance sheet of a business but are included on a "pro forma" balance sheet used for the sale of the business.
- Intangible assets are valued at the difference between the sales price of the business and the net value of all the assets and liabilities included in the sale.
    - For example if your total assets are valued at $75,000 but you are offering the business for sale at $100,000 you are assigning a value of $25,000 to goodwill.

Valuing Farm Specific Items on the Pro Forma Balance Sheet

- Equipment, infrastructure, and livestock held for breeding
  - Craigslist or local auction prices are resources to estimate fair market value for equipment and breeding livestock, as you can see what similar items are currently being sold for.
- Buildings and permanent crops
  - You can use the estimated cost to replace or rebuild or re-plant those assets.
  - Can be valued by an agricultural appraisal. If you are selling a significant amount of equipment and other assets, this third-party opinion can justify the price you are asking. Agricultural appraisals range in cost depending on the location and amount of equipment. In our experience, they can cost between $1,000 and $4,000.
- Growing crops
  - Growing crops are difficult to value but you can estimate their value at either the annual costs to date that have gone into the crop or at a percentage of the sales price you expect to receive - for example if the crop is 50% of the way to maturity you would value it at 50% of the expected revenue.
  - Or, an agricultural appraiser can provide an estimate of the crop value.