Determining Worth: BUSINESS VALUATION

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Presenter’s Background

- Valuation firm partner since 1999
- Prior experience leading valuation practice for large CPA firm
- Experience teaching valuation topics for more than 10 years
- Expert witness in federal and state court on valuation issues
- Worked with hundreds of clients on value determination for:
  - Transfer tax (gift & estate valuations)
  - ESOP
  - Fair value for financial reporting
  - Business transactions (buy and sell)
  - Litigation matters
    - Shareholder disputes
    - Divorce
Overview

- Standards of value
- Motivation to change value of a business
- Valuation methodologies
- Value drivers
- Preserving value
What is the Value of a Business?
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It depends! Why do you need to know the value?
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- Standards of value
What is the Value of a Business?

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- **Standards of value**
  - *Fair market value*
    - Revenue Ruling 59-60
    - Hypothetical buyer & seller, cash transaction
    - Tax-based valuations
What is the Value of a Business?

It depends! Why do you need to know the value?

- Standards of value
  - Fair market value
    - Revenue Ruling 59-60
    - Hypothetical buyer & seller, cash transaction
    - Tax-based valuations
  - Fair value
    - Statutory definition of value
    - Applicable to:
      - Divorce, Shareholder Disputes, Oppressed Shareholder Claims (Buy-sell agreement advisory!)
What is the Value of a Business?

It depends! Why do you need to know the value?

- Standards of value
  - Fair value
    - Financial reporting for GAAP purposes
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  - Fair value
    - Financial reporting for GAAP purposes
  - **NOTE:** “Fair Value” & “Fair Value” are not the same!
What is the Value of a Business?

It depends! Why do you need to know the value?

- Standards of value
  - Fair value
    - Financial reporting for GAAP purposes
  - NOTE: “Fair Value” & “Fair Value” are not the same!
  - Investment or strategic value
    - Value to a particular buyer
    - Merger/acquisition
  - Other standards of value exist
What is the Value of a Business?

It depends!

- Control vs. Minority Interest
What is the Value of a Business?

It depends!

- **Control vs. Minority Interest**
  - Under “Fair Market Value” and some other standards of value – Minority interest is **NOT** a proportionate share of enterprise value
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    - Enterprise Value – 100% Company Value
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  - Under “Fair Market Value” and some other standards of value – Minority interest is **NOT** a proportionate share of enterprise value
    - Enterprise Value – 100% Company Value
    - A minority interest of 20% is not valued at Enterprise Value x 20% because:
      - Discount for lack of control
      - Discount for lack of marketability
      - Other applicable discounts
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      - Discount for lack of control
      - Discount for lack of marketability

- **Fair market value vs. Fair value** *(Buy-sell advisory!)*
Motivations for Value Change
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The Conundrum of Valuation
Motivations for Value Change

The Conundrum of Valuation

- Those wanting a higher value
- Those wanting a lower value
Motivations for Value Change

The Conundrum of Valuation

- Those wanting a **higher** value
  - Transaction participants
  - Business partners in litigation
  - Divorcing spouses
  - Estate administrators
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Motivations for Value Change

The Conundrum of Valuation

- **Business appraisers are NOT advocates!**
  - Theoretically speaking, given the same access to information, we will reach the same conclusion of value no matter which party retains us.
  - We are ethically bound to remain objective and unbiased.
    - There are many sets of professional standards to which we must conform, depending upon credentials and designations.
  - HOWEVER, the reality is when parties are in dispute (i.e., litigation), seldom do appraisers retained by the separate parties reach a consensus.
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- Business appraisers are NOT licensed!
Pros & Cons of Value Determination
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Pros

👍 We have prescribed valuation methodologies
👍 Generally, buyers want cash flow or assets
👍 Business sellers should plan ahead
  ▪ Get the business ready to sell years in advance (NOT months)
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Cons

👎 Buyers don’t care what sacrifices the seller had to make to start or grow business
👎 BST Method not used (i.e., “Blood, Sweat & Tears”)
👎 Buyers recognize “paint on a pig”
  ▪ Due diligence can be a seller’s worst nightmare
Methodologies & Value Drivers
Methodologies

Three Valuation Approaches
Methodologies

Three Valuation Approaches

- **Income Approach**
  - Capitalization of cash flow or income
  - Discounted cash flow or income
Methodologies

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- **Market Approach**
  - Guideline public companies
  - Guideline transactions
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  - Discounted cash flow or income

- **Market Approach**
  - Guideline public companies
  - Guideline transactions

- **Asset Approach**
  - Net asset value (includes intangible value component)
Methodologies

Income Approach – What are the value drivers?
Methodologies

**Income Approach** – What are the value drivers?

- **Cash Flow** is a King
  - *Direct* relationship between cash flow & value
    - ✷ Cash Flow yields ✷ Value
  - Cash rich businesses command a higher value
Methodologies

**Income Approach** – What are the value drivers?

- **Cash Flow** is a King
  - *Direct* relationship between cash flow & value
    - ↑ Cash Flow yields ↑ Value
  - Cash rich businesses command a higher value

- **Risk Profile** is a significant consideration
  - *Inverse* relationship between risk & value
    - ↓ Risk yields ↑ Value
  - Low risk businesses are valued more
Methodologies

Market Approach – What are the value drivers?
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- **Profitability** is the main value driver
  - *Direct* relationship between profitability & value
    - † Profitability yields † Value
  - Profitable businesses are more easily marketed and bring a higher value
  - Buyer’s don’t pay for “profit potential” if they have to do the work & incur the expense to make it happen
  - Value based on multiples of earnings – EBITDA, EBIT, etc.
Methodologies

Asset Approach – What are the value drivers?
Methodologies

**Asset Approach** – What are the value drivers?

- **Composition** of assets
  - Low value assets vs. high value assets
  - More appropriate when investing in asset-intensive businesses
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- **Condition** of assets
  - State of the art vs. outdated
Methodologies

**Asset Approach** – What are the value drivers?

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- **Condition** of assets
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- **Debt structure**
  - No debt vs. Reasonable debt level vs. Highly leveraged
Methodologies

For All Three Approaches

- **Qualitative Factors**
  - Must be assessed
  - Importance of factors will vary from:
    - Company to company
    - Method to method
Value Drivers

Summary of Value Drivers

- Cash flow
- Profitability
- Risk profile
- Composition & condition of assets
- Debt structure
- Qualitative factors
Value Drivers

Qualitative Assessment
Value Drivers

Qualitative Assessment

- Industry
  - Looming changes to the industry
  - How adaptive is the company to industry changes?
  - Industry forecasts
Value Drivers

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  - How adaptive is the company to industry changes?
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- Management & employees
  - Depth of management (ALERT: Key Person Discount)
  - Concentration of proprietary knowledge
  - Succession plan in place
  - Skilled labor force
Value Drivers

Qualitative Assessment

- Products & services
  - Breadth of product or service line
    - Too narrow – risk increases due to lost business
    - Too broad – lack of specialization
Value Drivers

Qualitative Assessment

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- **Customers**
  - Concentration of customer base (*ALERT: Low pctg of revenues from single or few customers lowers value*)
  - Geographic diversity
  - Distribution channels
Value Drivers

**Qualitative Assessment**

- Competitors
  - Level of competition
  - Company’s market share
Value Drivers

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- Benchmark analysis
  - Comparison to industry segment
    - Profit margins, ROI, return on assets, turnover ratios
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- Advisors
  - Does company have a professional advisory team
  - Board, CPA, attorney, IT, insurance agent, etc.
Value Drivers

Cash Flow Assessment
Value Drivers

Cash Flow Assessment

- Source Analysis
  - Statement of Cash Flows
    - Operations, Financing and Investing Sources & Uses
    - ALERT: Know how to read a Statement of Cash Flows! The buyer knows how!
  - Cash available for capital improvements
  - Ability to pay down debt
  - Distribution history
  - Is buyer’s cash flow sufficient to service acquisition debt?
Value Drivers

Profitability Assessment
Value Drivers

**Profitability Assessment**

- **Trend Analysis** – rear view mirror assessment
- **Forecast** – forward-looking assessment
- **Operating vs. non-operating expenses**
  - Eliminate non-operating expenses
  - Consider ceasing non-operating expenses in preparation for sale of company
- **Recurring vs. non-recurring expenses**
  - Eliminate non-recurring expenses
Value Drivers

Risk Assessment
Value Drivers

Risk Assessment

- Competition risk
  - How competitive is the industry segment and market
Value Drivers

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- Management risk
  - Risk that a significant amount of proprietary knowledge or business relationships are concentrated
Value Drivers

Risk Assessment

- Competition risk
  - How competitive is the industry segment and market

- Management risk
  - Risk that a significant amount of proprietary knowledge or business relationships are concentrated

- Financial risk
  - Can the company meet short-term (i.e., one year) obligations
Value Drivers

Risk Assessment

- Economic risk
  - Susceptibility of profits to economic fluctuations
Value Drivers

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- Customer risk
  - Fewer customers mean higher risk
Value Drivers

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  - Shortages of product increase risk
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Risk Assessment

- Economic risk
  - Susceptibility of profits to economic fluctuations
- Customer risk
  - Fewer customers mean higher risk
- Supplier risk
  - Shortages of product increase risk
- Environmental risk
  - Buyers do not want to acquire a hazardous site
Risk Assessment

- Product or service risk
  - Do the products/services have liability issues
Value Drivers

Risk Assessment

- Product or service risk
  - Do the products/services have liability issues

- Technology risk
  - Is changing technology putting the company’s products or services at risk
Value Drivers

Risk Assessment

- Product or service risk
  - Do the products/services have liability issues
- Technology risk
  - Is changing technology putting the company’s products or services at risk
- Industry risk
  - Is the company keeping up with the industry
Value Drivers

Composition & Condition of Assets
Value Drivers

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- Receivables
  - Old and uncollectible?
  - Net receivable value ("NRV") close to book value?
    - If not, why?
Value Drivers

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- Fixed assets
  - State of the art or outdated
  - What future investment will a buyer need to make to bring the capital plant up-to-date?
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- Non-operating assets?
Value Drivers

Composition & Condition of Assets

- Did the current owner protect the technology or intangible assets?
  - Patents
  - Trademarks
  - Copyrights
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- Working capital
  - Excessive?
  - Deficient?
Value Drivers

Debt Structure Assessment
Value Drivers

Debt Structure Assessment

- High debt vs. low/reasonable debt
- Key question – if someone buys the business, can they meet acquisition debt service from company cash flow?
- Borrowing capacity
Value Drivers

Company-specific Assessment
Value Drivers

Company-specific Assessment

- Important questions to ask:
  - Who transitions the business to the new buyer?
  - Will the seller stay on as an employee/consultant?
  - Are family members going to stay on?
  - How likely are key employees to stay?
  - Remember – people hate change
  - Is there going to be a non-compete with the seller?

- Key - What is the buyer’s upside potential
Preserving Value

Once you have built value, make sure you preserve it!
Preserving Value

Safeguard Assets

- Strong internal controls
  - Separation of duties
  - Mandatory vacations
  - Cross-trained employees
  - Background checks
  - Properly identify and track tangible assets

- Hands-on financial management
- Trust but verify!
Questions?

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