

What's Your Company Worth?

Valuation Issues Arising on Private Business Sales

Presentation Agenda

- **What is Value?**
- **Valuation Approach Overview**
- **Using Comparables and Rules of Thumb**
- **Goodwill: Commercial v. Personal**

What is Value?

Fair Market Value (FMV)

- **Definition:**
 - The highest price available
 - In an open and unrestricted market
 - Between informed and prudent parties
 - Acting at arms' length
 - Under no compulsion to act
 - Expressed in terms of money
- **Value may not equal price**

Valuation Approach Overview

Going Concern v. Liquidation



No

Yes

Liquidation Approach

- Asset Based Methodology
 - Asset proceeds net of:
 - Liabilities
 - Liquidation Costs
 - Appropriate income tax

Secondary Approaches

Going Concern Approach

- Asset Based Methodology
- Cash/Earnings Methodology
- Market Comparables
- Precedent Transactions
- Rules of Thumb

Going Concern Methodologies

- **Earnings Based Methods**
 - After-tax Earnings
 - Earnings Before Taxes (EBT)
 - Earnings before Taxes, Interest and Depreciation (EBITDA)
- **Cash Flow Based Methods**
 - Discounted Cash Flow
 - Capitalized Cash Flow

Capitalized Earnings (Cont'd)

Redundant v. Operating Assets

- Redundant assets are not required for operations and should be added to value

Common Redundant Assets

- Excess cash or working capital
- Non-operating investments
- Under or over leveraged interest bearing debt

Don't give them away

- Often better to extract the redundant assets prior to sale to maximize value

Normalized Earnings / Cash Flow

- **If using historical results one must normalize operating results**
- **Common normalization adjustments include:**
 - Management compensation that is not reflective of market
 - Investment income from non-operating assets

Normalized Earnings / Cash Flow (Cont'd)

- Unusual/Non-recurring transactions:
 - Gains or losses on disposition of assets
 - Severance payments
 - Etc.

Maintainable Earnings / Cash Flow

- Value is based on future earnings
- Calculate maintainable after-tax earnings / EBIT / EBITDA / cash flow by:
 - Reviewing historical results
 - Reviewing available forecasts, if prepared
 - Considering external industry and economic factors that impact earnings
 - Examine trending results

Using Comparables, Recent Transactions and Rules of Thumb

Public Comparable Analysis

- **Issues in using to value private company:**
 - Represents value of a single share
 - Stock may be thinly traded
 - Represents an investment in a public company that:
 - Is more liquid
 - Likely has greater access to capital
 - May be more diversified

Recent Transaction Analysis

- **Using precedent market transactions as guidelines in selecting the appropriate multiple or discount rate**
- **Issues:**
 - Difficult to find timely transactions in certain industries

Recent Transaction Analysis (Cont'd)

- Transactions often involve large, non-comparable public companies
- Purchase price may include synergies that are difficult to quantify

Rules of Thumb

- **Should rarely be used as a primary approach.**
- **Yardstick or secondary test at best.**
- **Industry dependant:**
 - Multiple of revenue
 - Value per customer

Rules of Thumb (Cont'd)

- **Must be certain that you understand what value the rule of thumb represents:**
 - Goodwill?
 - Asset value?
 - Equity value?

Goodwill: Commercial v. Personal

Commercial v. Personal Goodwill

- **Personal Goodwill:**
 - Accrues to a person because of his/her skills, personal reputation
 - Is not transferable and, therefore, has no commercial value

Commercial v. Personal Goodwill (Cont'd)

- **Converting Personal to Commercial:**
 - Common for private business owner to remain for a period post transaction to transition relationship with business contacts/customers to new owner

Earnout Issues

Re: Sale of a Private Business

Earnouts

- **Not uncommon for negotiations to break-down because the purchaser and vendor do not agree as to the business' future earnings capability.**
- **Earnouts have been used as a means to complete a deal.**
 - Purchaser agrees to pay more providing that the company hits certain earnings targets

Earnouts (Cont'd)

- **Pitfalls:**
 - Vendor may no longer be able to control/influence business' earnings capability
 - Difficult to define terminology (e.g., non-recurring transactions)
 - Potential tax considerations regarding capital v. income