Agenda

The Need for Business Valuations

Planning | Tax | Disputes | Deals

01

Valuation Methods & Value Enhancement Strategies

Cost, Market & Income Approach | Key Value Drivers

02

Red Flags in Business Valuations

What to look out for when reviewing the appraisal report

03

Discounts for Lack of Control & Marketability

Data Sources | Factors Impacting Magnitude of Discounts

04

Valuation Purpose

- Sale/Purchase
- Estate & Income Tax Planning
- Ownership Disputes
- Divorce
- ESOPs
- Buy-Sell Agreements
- Succession / Exit Planning

Exit Options

- ❖the next generation
- ❖existing shareholders or management
- ❖Employee Stock Ownership Plan
- ❖competitor / industry participant
- ❖financial buyer / private equity
- ❖turn out the lights!

Fair Market Value vs. Deal Terms

- All cash deal
- Seller's note
- Earn-out
- Claw-back provision
- Employment & Non-compete agreements
- Asset v. Equity transactions

Historical Financial Analysis

- “Normalize” financial statements
  - Remove non-operating assets & liabilities
  - Remove discretionary expenses
  - Eliminate impact of non-recurring events
- Identify trends
- Compare to the industry

Typical Income Statement Adjustments

- Non-recurring Events
  - Large one-time sale
  - Insurance proceeds
  - Major software conversion

- Discretionary Expenses
  - Compensation to owner-managers **not** at market
  - Rent rates for related party real estate **not** at market
  - Club dues, unnecessary travel, kid’s payroll/insurance
  - Aircraft expense, beach house maintenance

Typical Balance Sheet Adjustments

- Non-operating Assets
  - Cash not required to operate the business
  - Excess / obsolete inventory
  - Aircraft
  - Real estate not used in the business
  - Cash value of unnecessary life insurance

Valuation Approaches

- Cost approach
  - to establish a floor value
  - financially distressed or high risk businesses
- Market approach
  - comparison to similar businesses sold
- Income approach
  - present value of future expected cash flows

Prevalent Valuation Methods

Income Approach

- DCF – Invested Capital Method
- DCF – Equity Method
- Income Capitalization Method

Market Approach

- Guideline Public Company Method
- Private Transaction Method

Fair Market Value

Cost approach is typically employed for distressed businesses, asset holding companies or to establish a floor value.

Capital Structure – Value Perspective

Equity Value + All Interest-bearing Debt + Capitalized Lease Obligations = Invested Capital Value

P/E Multiple & DCF-Equity Method (Equity Value)

Invested Capital Value − Cash = Enterprise Value

DCF- Invested Capital Method (Invested Capital Value)

EBITDA Multiples* (Enterprise Value)

*For private transactions, EBITDA multiples are reported net of cash, in most cases

Income Approach

- Present value of future expected cash flows

  - Risk - Uncertainty of receiving future cash flows

  - Discount Rate = Return required by investors for taking the risk

Income Approach: Equity vs. Invested Capital Methods

Cash Flow to Equity Holders

Revenues - net
  Cost of Sales
Gross Profit
  Total Cash Operating Expenses
EBITDA
  Depreciation Expense
  Amortization
Operating Profit
  Other Income - net
EBIT
  Interest Expense
Pre-tax Income
  Less: Provision for Income Taxes
After-tax Income
  Plus: Depreciation & Amortization
Gross Operating Cash Flow
  Less: Addt'l Debt-free Working Capital Needs
  Less: Capital Expenditures
  Increase/(Decr.) in Net Debt Financing
  (Increase)/Decrease in All Other - Net
Net Cash Flow to **Equity Holders**

Discount Rate = Cost of Equity

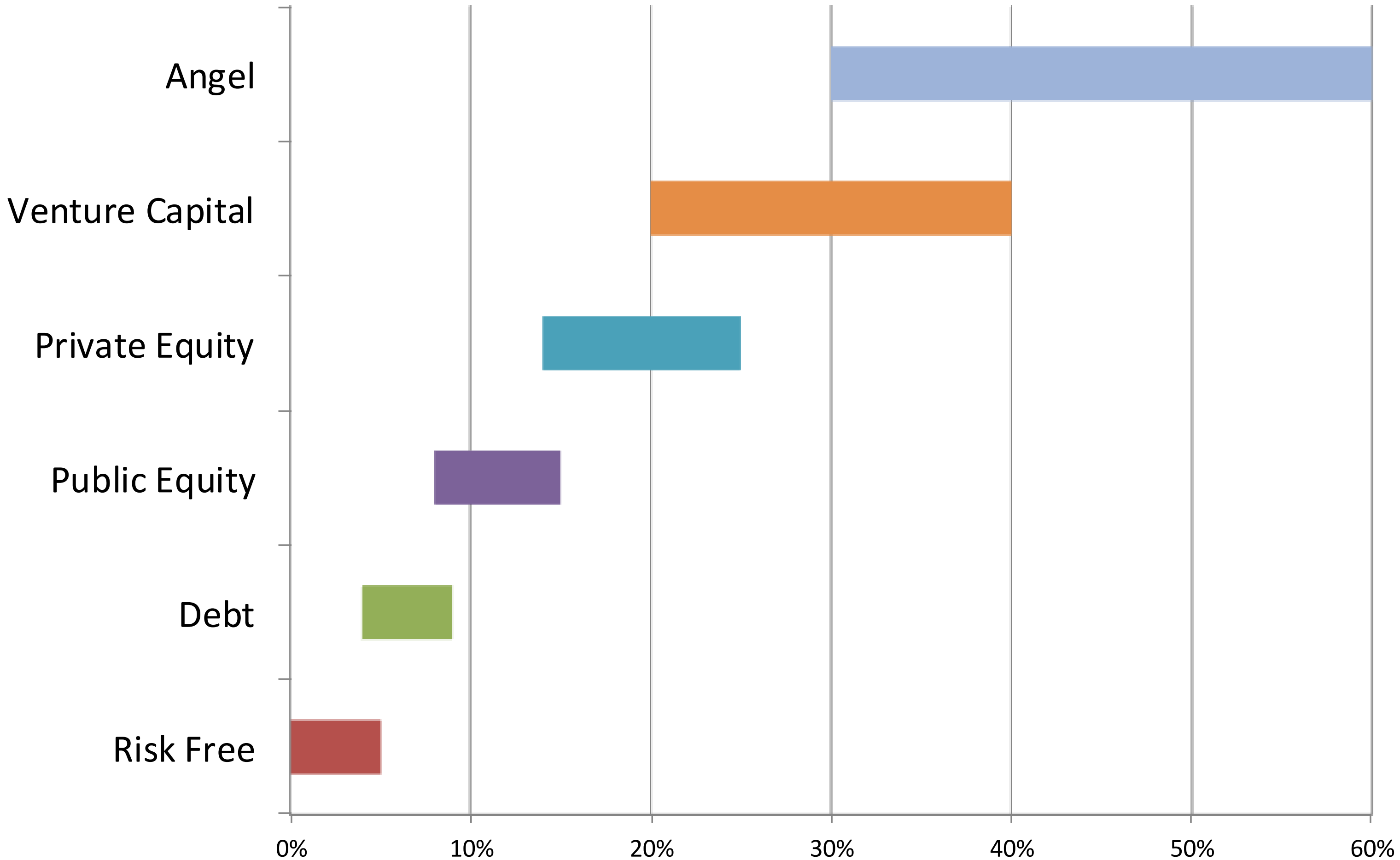
= Value of Equity

Cash Flow to Invested Capital

Revenues - net
  Cost of Sales
Gross Profit
  Total Cash Operating Expenses
EBITDA
  Depreciation
  Amortization
Operating Profit
  Other income - net
EBIT
  Less: Taxes
After-tax Income (EBIT)
  Plus: Non Cash Items
Gross Operating Cash Flow
  Less: Addt'l Debt-free Working Capital Needs
  Less: Capital Expenditures
  (Increase)/Decrease in All Other - Net
Net Cash Flow to **Debt & Equity Holders**

Discount Rate = Weighted Average Cost of Capital
Less: Interest Bearing Debt
= Value of Equity

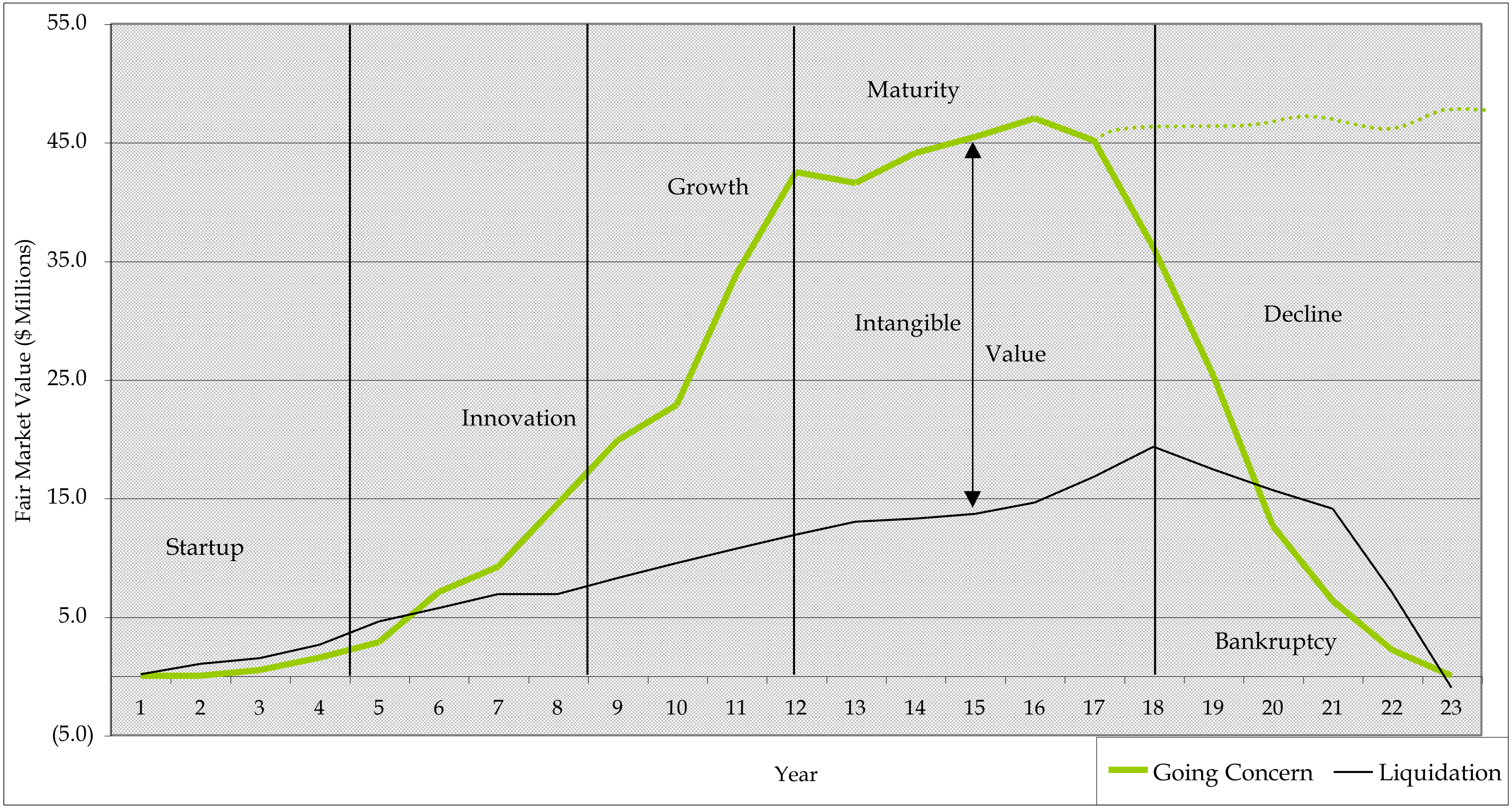
Cost of Capital



Source: Pepperdine Private Capital Markets Project

Handout

Typical Business Life Cycle



Value Plummets Ahead of Performance Drop

Crocs, Inc. - CROX

FAIRVALUE ADVISORS

Discounted Cash Flow Method

STRENGTHS	WEAKNESSES
Highly flexible – Business lifecycle	Supportability of assumptions
Multi-year projections	Specific vs. market participant
Explicit assumptions (more auditable?)	Opinions about risk & growth
Risk is addressed explicitly (Ke;Kwacc)	Potential for lots of details
Growth explicitly forecasted	More labor intensive
Direct impact of asset needs	Subtle opportunities for abuse

Guideline Public Company Method

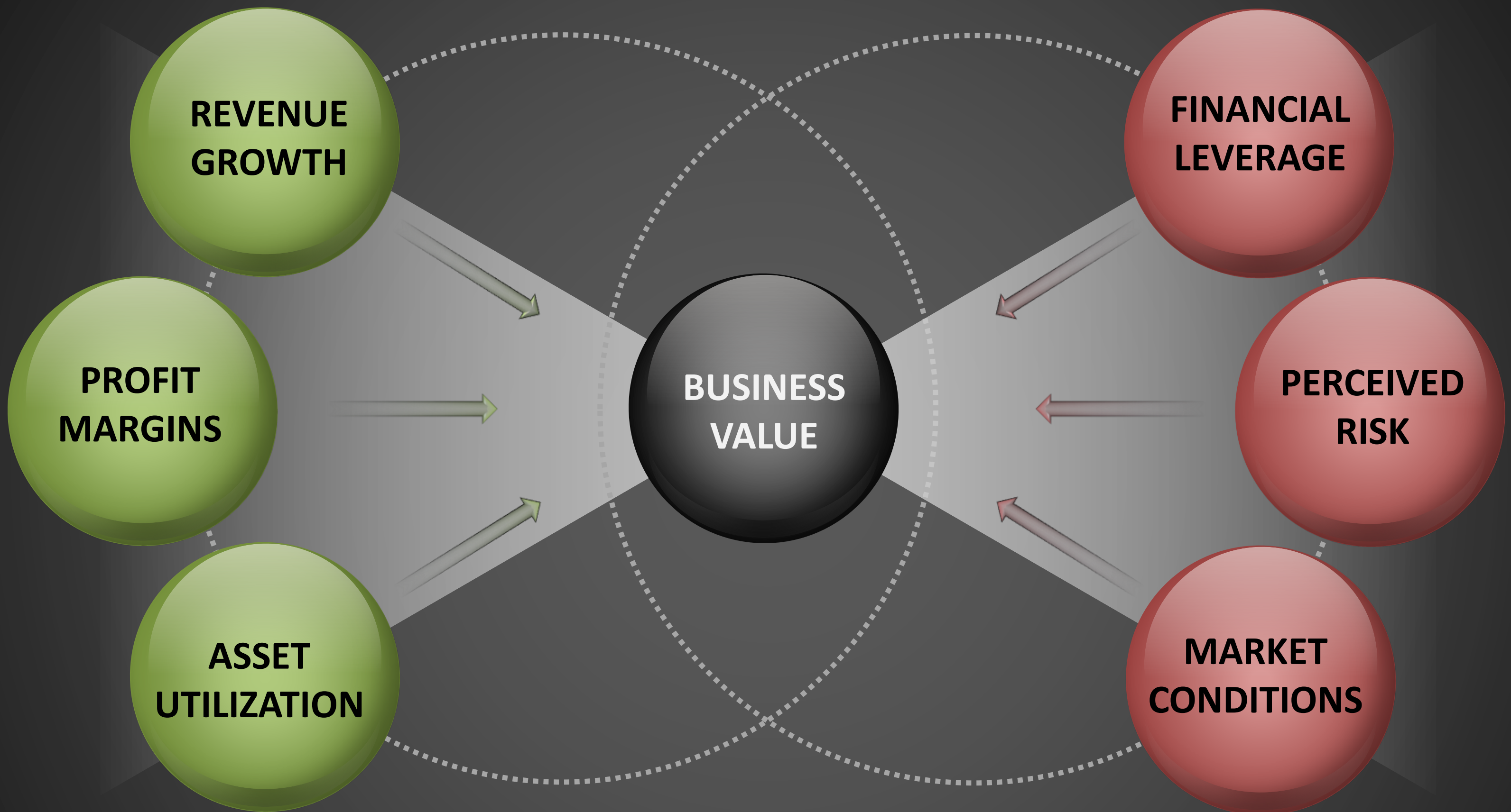
STRENGTHS	WEAKNESSES
15,000+ U.S publicly-held companies	Often very large companies – limited comparability to small businesses
Access to historical financials & trends	Lack of pure plays
Market multiples are easy to calculate	Risk - implicit in price multiples
Popular: P/E & EBITDA multiples	Growth - implicit in price multiples
Analysts' earnings & growth est., forward multiples (next. 12 mos.)	Asset needs - implicit in price multiples

Private Transaction Method

STRENGTHS	WEAKNESSES
Based on actual private transactions	No information about risk & growth
Market participants	No historical financial performance information (trend data)
Large # of transactions = market?	EBITDA multiples are often unreported, w/ or w/o adjustments?
Popular – Focus on EBITDA multiples	Asset needs - implicit in the multiple

What makes a business valuable?

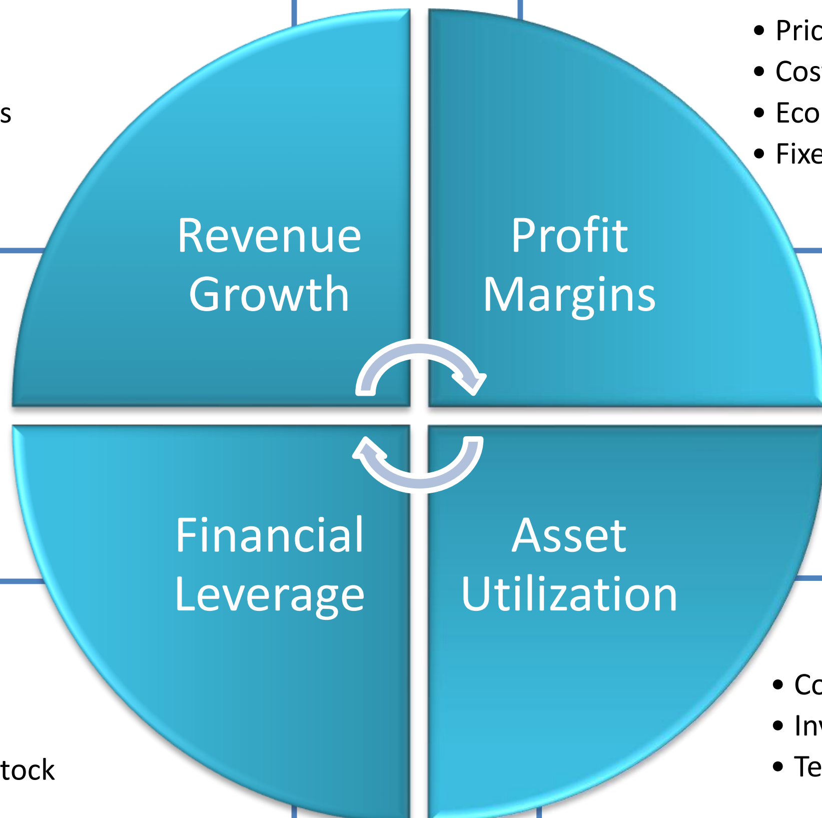
Key Factors Impacting Value



Key Financial Metrics Impacting Value

- Existing customer penetration
- New customers
- Geographic expansion
- New product/service offerings
- Pricing

- Margin stability
- Price pressures/increases
- Cost containment
- Economies of scale
- Fixed expenses



- Debt capacity v. Debt usage
- Cost of debt
- Hybrid securities /Preferred Stock

- Collection period
- Inventory turnover
- Technology & Expenditure levels

Common Business Risks

- ❖Key person dependence / lack of management depth
- ❖Tribal knowledge instead of documented business systems & processes
- ❖Dependence upon a few key customers
- ❖No alternative suppliers
- ❖Highly unpredictable revenue or profits

Market Conditions

- Industry conditions
- Economic conditions
- Access to capital
- Cost of capital
- Supply/Demand of businesses for sale

Value Enhancement - Revenues

❖ Increase Revenue Growth

- marketing efforts - volume from existing customers vs. new customers
- pricing strategy
- new product/service introductions
- geographic expansion
- economic & industry conditions

Value Enhancement - Margins

❖ Improve Profit Margins

- pricing
- cost containment
- fixed vs. variable expenses
- labor vs. technology & capex

Value Enhancement – Assets & Financing

- Improve Asset Utilization
  - shorten collection period
  - increase inventory turnover
  - reduce capital expenditure levels
- Use Optimal Debt Levels

Value Enhancement - Risk

- Decrease Risk
  - reduce key person dependence
  - diversify the customer base (lower customer concentration)
  - increase product/service portfolio
  - extend life of existing product/service offerings
  - reduce supplier dependence

Red Flags When Reviewing the Valuation Report

Reviewing a Valuation Report

- Qualifications
  - Educational Background
  - Certifications / Designations
  - Years of Full-time Experience

Reviewing a Valuation Report (continued)

- Due diligence - Site Visits & Mgmt. Interviews
- Report format
  - Full Narrative / Comprehensive
  - Summary
  - Schedules
- Financial statement adjustments
- Methodology employed

Reviewing a Valuation Report (continued)

- Using business transactions that are not comparable
- Price multiple inconsistent with risk & growth
- Unrealistic projections & assumptions
- Discount rate (required return) inconsistent with risk
- Broad range of value indications

Lack of Control Discounts

<u>Inability to control</u>:

- ❖ Distribution levels, policy or timing
- ❖ Repurchase of outstanding equity
- ❖ Management decisions and business strategy
  - expansions, new products/services, pricing,
  - capital structure, sale/purchase of assets

Lack of Control Discounts

Data Sources:

- Control premium studies
- Closed-end funds

Lack of Marketability Discounts

"It seems clear...that an unlisted closely-held stock of a corporation..., in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public."

Central Trust Co. v. U.S., 305 F. 2d 393 (Ct. Cl., 1962)

Lack of Marketability Discounts

Magnitude of Discount

- ❖ Likelihood of distributions
  - distribution history
  - distribution capacity/ability
  - distribution policy
- ❖ Quality/liquidity of the underlying assets/business
- ❖ Potential future liquidity / specific rights or restrictions

Lack of Marketability Discounts

Data Sources & Methods:

- IPO Studies
- Restricted Stock Databases
- Option Models
- Implied Rate of Return with discounts

Questions & Contact Info

Rich Goeldner ASA, CBA, CVA

813.361.1382

888.212.0495 ext. 103

rich@fairvalueadvisors.com

www.fairvalueadvisors.com

Atlanta | Coastal GA | Jacksonville | Orlando | Tampa