

Valuing a Small Business

Greater New Orleans
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Overview

1. Reasons for a Business Valuation
2. Definitions
3. Difference between a Large and Small Business
4. Analyzing Qualitative Factors
5. Valuation Process
6. Making a Sanity Check
7. Types of Buyers
8. Tradeoff between Cash and Terms

1. Reasons for a Business Valuation

Common Reasons

- Merger/ Acquisition/ Fairness Opinions
- Family Succession Planning/Estate and Gift Taxes
- Employee Share Ownership Plans (ESOP)
- Buy-Sell Agreements
- Executive Compensation (Options/SARS)
- Stock Repurchase of Recapitalization
- Fair Value Accounting
- Income Tax

2. Definitions

EBITDA

Earnings before interest expense, taxes,
depreciation and amortization

Net income

+interest expense on long term debt

+ income taxes

+depreciation and amortization

EBITDA

Total Enterprise Value

- (“TEV”) = equity + long term debt
- Pricing multiple = (Equity + LT debt)/EBITDA
- Equity = pricing multiple x EBITDA – LT debt.

Fair Market Value

- The amount at which the capital stock of the company would change hands between a willing buyer and a willing seller, each having reasonable knowledge of the relevant facts, neither being under any compulsion to act.

3. Differences between the Valuation of a Large and Small Business

Differences between the Valuation of a Large and Small Business

- What is a Small Business?
- Status of Financial Statements
- Stock versus Asset Transaction
- Consideration Offered by Purchaser
- Comparative Transaction Data Available
- Role of the Owner/Manager
- Motivation of the Buyer
- Compensation to Owners

What is a “Small” Business?

- Small is difficult to define.
- The range is from “mom and pop” businesses up through those worth around \$5 million.
- The key point of “small” in most cases is the personal involvement of the owner or owners in the operation of the business or practice.

Status of Financial Statements

- Audited Statements
- Reviewed Statements
- Compiled Statements
- Tax Returns Only
- Responsibility for Forensic Accounting
- Records in a Shoe Box

Stock versus Asset Transaction

- Stock Valuation
 - Need to determine whether there will be any major changes from the statements on which the valuation is based
 - For example, any major cash withdrawal or any significant off-balance sheet liabilities or assets
- Asset Transaction
 - It is necessary to define what assets are being transferred and what, if any liabilities are being assumed by the buyer

Consideration Offered by Purchaser

- Most businesses are sold for a combination of
 - Cash
 - Contract balance and/or
 - Stock of the acquiring Company
- It is important to evaluate the strength of the contract and all of the terms
- If the stock of the acquiror is part of the deal, the stock must be valued

Comparative Transaction Data Available

- For the market approach, actual transaction prices of similar businesses are used for a comparison.
- For large companies, transactions in stocks of publicly traded companies are used.
- However, small companies and practices are in industries or professions that do not have publicly traded companies.

Role of the Owner/Manager

- The smaller the business, the more important the role of the Owner/Manager needs to be evaluated.
 - How much of the success of the Company is dependent on the Owner/Manager?
 - Is the success transferable to the new Owner?
 - Is there a noncompete agreement in the deal?
 - Is the seller providing help with the transition to the new Owner?

Motivation of the Buyer

- “Buy a Job”
 - Investment Value
- Multiple Transactions
 - Fair Market Value

Compensation to Owners

- When a small business is valued based on profits, it is important to analyze the compensation to the Owners.
- Small businesses, unlike large companies, may not compensate their owners at a market rate.
- Small companies pay what is available from the earnings/cash flow.

4. Analyzing Qualitative Factors

Analyzing Qualitative Factors

- Relevant Economic Data
- Industry Factors
- Competition
- Regulation
- Product or Service Lines
- Supplier Relationships
- Market Position
- Management and Employees
- Adequacy of Physical Facility
- Operating Efficiencies and Inefficiencies

Relevant Economic Data

- National Economic Data
- Regional and Local Economic Data

Industry Factors

- Markets
- Channels of Distribution
- Technology
- Sources of Industry Information

Competition

- Existing Competition
- Potential Competition

Regulation

- Present Regulation
- Potential Changes in Regulatory Environment

Product or Service Lines

- Existing Lines
- Opportunities for Related Lines
- Patents, Copyrights, Trademarks
- Relative Profitability of Lines
- Service or Warranty Obligations

Supplier Relationships

- Continuity
- Degree of Exclusivity
- Contractual Relationships

Market Position

- Reputation
- Geographic Scope
- Method of Marketing and Distribution
- Pricing Policies
- Customer Base
- Customer Relationships
- Market Continuity, Growth Opportunities and Weaknesses

Management and Employees

- Size and Composition of Work Force
- Key Employees
- Other Employees
- Compensation
- Personnel Policies, Satisfaction, Conflict, and Turnover

Adequacy of Physical Facility

- Condition
- Heat, Light, Plumbing, and Other Systems
- Size
- Continuity of Occupancy

Operating Efficiencies and Inefficiencies

- Physical Plant
- Accounting and Other Controls

5. Valuation Process

Steps in the Valuation Process

- Gather Company data
- Site Visit
- Research economic and industry information
- Analyze company financial statements
- Tests of Valuation
- Discounts, Premiums and Value Conclusion

Valuation Methodologies

Comparison to Mergers & Acquisitions	Demonstrates how acquirors have valued comparable companies in recent change of control transactions.
Discounted Cash Flow Analysis	Used by corporate buyers to derive a value based on the Company's future levered free cash flows, discounted at a risk-adjusted rate.
Leveraged Buyout Analysis (Sanity Check)	Used by financial buyers to derive a value that provides an adequate return on invested equity based on the Company's expected future cash flows and the current terms and availability of debt financing.
Net Asset Value (NAV)	The Net Asset Value represents the market value of the assets less liabilities

Adjustments to Financial Statements

- Balance Sheet
 - Non-Operating Assets
 - Market Value versus Book Value
- Income Statement
 - Non-recurring items
 - Add backs
 - Deducts
 - Tax Adjustments

Company A
Balance Sheet as of December 31, 2002

	Reported		Adjusted		Market Value Adjusted
Cash	100,000		100,000		100,000
Marketable securities portfolio	750,000	(750,000)	0		0
Accounts receivable	500,000		500,000		500,000
Inventory	300,000		300,000		300,000
Total Current Assets	1,650,000		900,000		900,000
Property Plant & Equipment	1,000,000		1,000,000		
Accumulated Depreciation	(600,000)		(600,000)		
Net PP&E	400,000		400,000	500,000	900,000
Hunting Camp	50,000	(50,000)	0		0
TOTAL ASSETS	2,100,000		1,300,000		1,800,000
Accounts payable	400,000		400,000		400,000
Accrued Expenses	100,000		100,000		100,000
Total Current Liabilities	500,000		500,000		500,000
Long term debt	300,000		300,000		300,000
Total Liabilities	800,000		800,000		800,000
Equity	1,300,000		500,000		1,000,000
TOTAL LIABILITIES & EQUITY	2,100,000		1,300,000		1,800,000

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Company A
Income Statement For the year ended December 31, 2002

	<u>Reported</u>		<u>Adjusted</u>
Revenue	2,000,000		2,000,000
Cost of Revenue	1,000,000		1,000,000
Gross Margin	<u>1,000,000</u>		<u>1,000,000</u>
Operating Expenses			
Owners salary	300,000	(200,000)	100,000
Other Salaries	500,000		500,000
Rent	50,000		50,000
Depreciation	50,000		50,000
Interest Expense	2,100		2,100
Hunting camp expenses	5,000	(5,000)	0
Other Expenses			
Total Operating expenses	907,100		702,100
Investment Income	30,000	(30,000)	0
Pre tax Income	122,900		297,900
Income Taxes	49,160		119,160
Net Income	<u>73,740</u>		<u>178,740</u>
Depreciation	50,000		50,000
Capital Expenditures	(50,000)		(50,000)
Change in Working Capital	(15,000)		(15,000)
Free Cash Flow after tax	58,740		163,740
Net Income	<u>73,740</u>		<u>178,740</u>
Interest Expense	2,100		2,100
Income Taxes	49,160		119,160
Depreciation	50,000		50,000
EBITDA	175,000		350,000

Approaches to Business Valuation

- I. Asset-Based Approach
- II. Market Approach
- III. Income Approach

Approaches to Business Valuation

I. Asset-Based Approach

- Adjusted Book Value Method

Approaches to Business Valuation (Cont.)

II. Market Approach

- Previous Sales of or offers for the Company's Stock
- Sales of Similar Companies
- Sales of Stock of Publicly Traded Companies
- Rules of Thumb

Gross Revenue Multipliers (Price-to-Sales Ratio)

- The Basic Concept
- When Gross Revenue Multipliers May Be Useful
- Problems in Using Gross Revenue Multipliers

The Basic Concept

- The value is some multiple of the amount of revenue that the entity generates.
- Categorized in a valuation as a method within a broader category, like the income or market approach, depending on how the multiplier is developed.

When Gross Revenue Multipliers May Be Useful

- When gross sales are the only reliable income data available
- For companies with losses or erratic earnings
- For highly homogeneous industries and professions
- Estimating value of intangible and/or other assets
- Where there is a high industry correlation between price and return on sales

Problems in Using Gross Revenue Multipliers

- Ambiguity as to exactly what was sold
- Ambiguity as to terms of sale
- A profit factor usually comes into play
- Differences in persistence of revenues
- Uniqueness of each entity
- Multipliers change considerably over time
- Even gross revenue data may not be reliable

Approaches to Business Valuation (Cont.)

III. Income Approach

- Capitalization of Earnings Method
- Discounted Cash Flow Method
- Leveraged Buyout
- Excess Earnings Method

Understanding Discount and Capitalization Rates

- “Discounting” versus “Capitalizing”
- Components of a Discount Rate
- Relationship between Discount Rates and Capitalization Rates
- Relating Discount or Capitalization Rate to Income Stream
- Relationship between *Payback Period* and *Capitalization Rate*
- Different Rates for Different Buyers

“Discounting” versus “Capitalizing”

- Discounting is a procedure that converts an expected future return, or a series of expected future returns, to a present value using a discount rate.
- Capitalizing is a procedure that converts a single flow of returns to an indication of value.

Components of a Discount Rate

- The discount rate is the expected total rate of return required to attract capital to the particular investments.
- Components
 - Risk-Free Rate of Return
 - Premium for Risk
 - Premium for Illiquidity
 - Premium for Administrative Costs

Relationship between Discount Rates and Capitalization Rates

- A **discount rate** converts **all** of the expected future return on investment to an indicated present value.
- A **capitalization rate** converts **only a single** return flow number to an indicated present value.
- Reflected growth or decline in expected returns
- Return **on** Investment versus Return **on and of** Investment.

Relating Discount or Capitalization Rate to Income Stream

LEVELS OF RETURNS THAT MAY BE DISCOUNTED OR CAPITALIZED

<u>Level of Return</u>	<u>Returns to Equity</u>	<u>Returns to Total Invested Capital</u>
Gross or net revenues	X	X
Owner's discretionary cash		X
EBDIT		X
EBIT		X
EBT	X	
Net income	X	
DFNI		X
Net free cash flow to invested capital		X
Net free cash flow to equity	X	

No matter how the income stream is defined, it is important that the rate selected is appropriate to the definition of the income stream.

Relationship between *Payback Period* and *Capitalization Rate*

- The payback period is the length of time required (usually in years) to recover the cost of an investment.
- The payback period becomes most relevant when returns beyond a relatively short time horizon are highly uncertain.
- The payback period is a supplemental tool, and it should not be used alone.

Different Rates for Different Buyers

- The cost of equity, either debt or equity, is different from one buyer to another.
- For an individual buying a sole proprietorship from another individual, each would have about the same cost of capital.
- For a public company, the cost of capital would be somewhat less than the typical small entrepreneur.

The Excess Earnings Method

- How It Works
- Denunciation by the IRS

How It Works

- Step by Step Explanation
 - 1) Determine a net tangible asset value.
 - 2) Determine a normalized level of earnings
 - 3) Determine an appropriate percentage rate of return or a capitalization rate on the net tangible asset value. Multiply Step 1 by the rate to determine the amount of earnings attributable to the tangible assets. Subtract that amount from Step 2. The result is the excess earnings.
 - 4) Determine an appropriate capitalization rate to apply to Step 3. Capitalize the earnings at that rate.
 - 5) Add the values from Step 1 and 4.

Denunciation by the IRS

- The IRS Appellate Valuation Training Program denounces the excess earnings method of valuation.
- “To attempt to segregate value based on earnings as between normal income and that induced by whatever goodwill or other intangible assets the business may possess is to aspire to a higher degree of clairvoyance than has yet been demonstrated as obtainable by mere man”*

6. Making a Sanity Check

Making a Sanity Check

- Cash Available for Debt Service
- Amount of Coverage Needed
- Possible Adjustments to the Contract
- Protective Covenants
- An Example

Cash Available for Debt Service

- Is income:
 - 1) Before interest and principal payments
 - 2) Before depreciation and amortization (or other noncash charges)
 - 3) After reasonable compensation for owner
 - 4) After capital expenditures, including both replacements and additions
 - 5) After federal and state income taxes

Amount for Coverage Needed

- The amount is dependent on the degree of risk in the expected cash flow.
- The entire income stream should not be used for debt service.
- Normally, no more than 50% of the cash flow is used for debt service.

Possible Adjustments to the Contract

- If terms of contract do not seem affordable, the following are possible adjustments:
 - Extending the length of the contract
 - Payments may be varied
 - Payments contingent on a level of cash
 - Longer-term amortization with a balloon payment.

Protective Covenants

- It is important to have covenants in the contract to protect the ability of the business to produce an adequate cash flow.
- Typical Restrictions
 - Owner's compensation
 - Capital expenditures
 - Investments outside the business
 - Assumption of other debt

MARY'S MACHINERY & EQUIPMENT, INC.
ANALYSIS OF DEBT SERVICE

Affordability of debt service related to the purchase of a company increases with either a decreased interest rate or increased term of the loan.

Length of Contract (Years)	5	5	10
Equity Value	\$575,000	\$575,000	\$575,000
Down Payment	200,000	200,000	200,000
Debt	375,000	375,000	375,000
Interest Rate	12.0%	6.0%	12.0%
Projected Pretax Income	100,000	100,000	100,000
Interest Expense Associated with Additional Debt	<u>45,000</u>	<u>22,500</u>	<u>45,000</u>
Adjusted Pretax Income	55,000	77,500	55,000
Statutory Taxes	<u>9,750</u>	<u>13,739</u>	<u>9,750</u>
Net Income	45,250	63,761	45,250
Plus:			
Depreciation	33,000	33,000	33,000
Interest Expense	<u>45,000</u>	<u>22,500</u>	<u>45,000</u>
Cash Available For Debt Service	123,250	119,261	123,250
Debt Service	<u>104,029</u>	<u>89,024</u>	<u>66,369</u>
Debt Service Coverage	1.18 x	1.34 x	1.86 x

Source: Pratt, Shannon P., and Robert Reilly, and Robert Schweih. Valuing Small Businesses and Professional Practices Second Edition. Homewood: Business One Irwin, 1993.

7. Types of Buyers

Industry Buyers

- Vertical
- Horizontal

Private Equity Buyers

- Platform
- Add On

Financial Buyers

- Management
- Employee

8. Tradeoff between Cash and Terms

Consideration

- Cash
- Restricted Stock
- Earn Out
- Escrow
- Seller Debt

Tradeoff between Cash and Terms

*“I’ll let you name any price you want
if you’ll let me name the terms.”*

Deal-Maker’s Credo

Seller Debt

- Example: Clarice sells her antique doll collection for \$100,000 with a 20% down payment.
 - Clarice sold the collection for \$20,000 cash, plus a note with a present value of \$65,007, which is a total of \$85,007.
- Some Variations
 - Extending the contract
 - Longer term decreases \$
 - Accepting a lower contract interest rate
 - Decreases \$
 - Variations in market rate of interest
 - Higher decreases \$
 - Combining the variations

Contingent Payments

- Many small businesses are sold at a “price” that is actually paid only if certain events occur.
- The most common contingency is the retention of current clients.
- To estimate a cash equivalent value of a price with contingencies, one must use their best judgment to assume a probability of the contingencies.

Sources

- **Pratt, Shannon P., and Robert Reilly, and Robert Schweihs. Valuing Small Businesses and Professional Practices Second Edition. Homewood: Business One Irwin, 1993.**

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Available at**

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