Business Valuation
For the Closely Held Business
Dan Doran, CVA

Mr. Doran is the principal owner of Quantive Business Valuations, a pure-play valuation firm working throughout the country. Mr. Doran has performed business valuations since 2004. He is a Certified Valuation Analyst (CVA) with experience in completing hundreds of valuations in various industries including, distribution, manufacturing, retail, service, and IT and internet related companies, amongst others. His practice includes valuations in support of purchases and sales, bank lending, litigation support & matrimonial matters, estate & gift tax, and 409(a) stock option pricing.

Prior to Quantive, Mr. Doran was a founding partner in a Middle Market M&A advisory firm. In that capacity, he focused his practice on sell-side advisory of privately held companies.

Mr. Doran earned a B.S. from the United States Military Academy at West Point.
AGENDA

- Value: Why does it Matter?
- Defining Value
- What Drives Value
- Models, Formulas, and Techniques
- What’s Next
Value: Why Does it Matter?
Wealth

80%

Percent of Wealth Attributable to Company Ownership

Retirement

20%

Percent of Owners With Exit Plan / Financial Plan

Source: Exit Planning Institute
Unlocking Wealth

Percent of Owners Intending to Exit in Next 5 Years: 50%

Achieving Success

Percent of Exits Successful on First Attempt: 10%
Barriers to Implementation

» Lack of articulation of strategies and objectives
» Insufficient KPIs
» Poorly defined tactics / not aligned with strategy
» Lacking accountability inside the organization
» No Quarterback - Disparate number of experts required in the process
» It’s Difficult - Delay is easier
Funding a successful retirement from exit proceeds requires careful planning.

20% Liquid Net Worth

You can’t plan when you don’t know.

Planning for the future requires an understanding of today’s facts.
Defining Value

Value is a moving target - it’s “whatever someone is willing to pay for it.”

So let’s start with that.
What is Value?

A fair return of equivalent in goods, services, or money for something exchanged; *Relative worth, utility, or importance*

Merriam-Webster

Context Matters.

Understanding value often begs the question “Value to whom?”
Why Value a Company?

- Purchase or Sale of a Business (M&A)
- Financing
- Estate and Gift Taxes
- Marital Dissolution
- C-Corp Conversions
- 409(a) - Equity Compensation
- Buy-Sell Agreements
- Life Insurance
- Stockholder Disputes
- Liquidation or Reorganization
- Damages Litigation
- Insurance Claims

- Charitable Contributions
- Eminent Domain Actions
- Financial Reporting
- Initial Public Offering
- Allocation of Purchase Price
- Employee Stock Ownership Plans
There are three economic principles that guide valuation theory:

- Alternatives: Each party has options in terms of investment choices.
- Substitution: Investors do not overpay vis-à-vis an equally desirable substitute.
- Future Benefits: Economic value reflects future benefits.

These principles help guide and inform the decisions made in the course of a valuation. We’ll see these principles return and interweave as we go through the various valuation methodologies that are commonly employed in developing value.
Standards of Value

- Fair Market Value
- Fair Value
- Intrinsic Value
- Investment Value
Standards of Value

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>FV</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Willing Buyer?</strong></td>
<td>Yes</td>
<td>Maybe</td>
</tr>
<tr>
<td><strong>Willing Seller?</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Compulsion to Transaction?</strong></td>
<td>Neither Buyer / Seller</td>
<td>Maybe</td>
</tr>
<tr>
<td><strong>Notional Parties?</strong></td>
<td>Both</td>
<td></td>
</tr>
<tr>
<td><strong>Price</strong></td>
<td>Equitable to both</td>
<td>Fairness to seller can be a consideration</td>
</tr>
<tr>
<td><strong>Equal Knowledge of Facts</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Discounts</strong></td>
<td>Yes, DLOM and DLOC as appropriate</td>
<td>Generally No</td>
</tr>
<tr>
<td><strong>Federal Tax Standard</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Divorce, Dissenting or Oppressed Shareholder</strong></td>
<td>Generally No</td>
<td>Generally Yes</td>
</tr>
</tbody>
</table>
What Drives Value

Not all widget manufacturers are the same.

Well, why not?
There are many characteristics that can reduce perceived risks to investors in a business. Elements that often characterize lower risk, higher value companies include:

- Strong margins
- Strong balance sheet
- Consistency of earnings
- Consistency of revenue
- Steady year-over-year growth
- Long term contracts
- Recurring revenue
- Proprietary products
- Unique selling proposition
- Niche products and services
- Well diversified customer base
- Strong management team
- Attractive / growing industries
- Strong financial controls
Valuation Models

Models, Formulas and Techniques

1. Standard of Value
2. Normalize
3. Model
4. Calculate
Getting to Normal

To get to a baseline, we make “normalizing adjustments” to reflect the steady state of the business. Normalizing adjustments can be looked at in several ways:

- One-Time / Unusual Expenses
- Non-Operating expenses
- GAAP Adjustments
- Discretionary Adjustments

“Unusual” Examples

- Jimmy’s college fund
- Lease on the Maserati
- A race horse

Non-Operating

- Replace the roof
- Investment income (expense)
- Expenses related to a spin-off
Weighting Performance

**Earnings History**

<table>
<thead>
<tr>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
</tr>
</thead>
<tbody>
<tr>
<td>-31,100</td>
<td>-37,800</td>
<td>32,400</td>
<td>53,800</td>
<td>16,500</td>
</tr>
</tbody>
</table>

**Simple Average:**

$6,552

**Weighted Average:**

$19,149

**Most Recent Year:**

$16,513

Will the Real Company Please Stand Up?

Investors “buy the future” but evaluate the past. How to reconcile?
Similar to real estate appraisal, business valuation has three basic approaches to consider:

- The Market Approach
- The Income Approach
- The Asset Approach

The analyst will typically consider all three approaches and how they might be applied to the subject company; however, that does not mean they will necessarily be used or relied upon.
The Market Approach

- “Probably” the most commonly used approach
- Can be difficult in practical application
- Think “Market Comps”

More Common
- Price / Earnings
- Price / Revenues
- Price / Gross Profit

Less Common
- Price / EBIT
- Price / Book*

*Often used for Financial Services
No Such Thing As Average

Don’t Be Average

Good companies (and investment bankers) demonstrate how the company is **above** average.
The income approach is primarily concerned with the future earnings power of the business.

- Capitalization: Presumes that current earnings reflect future earnings
- Discounting: Calculate the net present value of future earnings in today’s dollars

Discount Rate
In either case, we need to develop a Discount Rate which is then applied to the earnings stream. There are a number of methods to do so:

- Qualitative – direct selection of rate, often relying on various studies
- Capital Asset Pricing Model (CAPM)
- Weighted Average Cost of Capital (WACC)
- Build-up Method (BUM)
Build Up Method

\[ Ke = R_f + ERP + IRP_i + SP + SCR \]

Practice Pointers

» Subjectivity. The Specific Company Risk (SCR) is the item most likely to be disputed as it is the most subjective.

» Relative Risk. Understanding the relative risk factors in a business helps make informed decisions as to validity of SCR.

» IRP can be misleading. Example: “Restaurants” have a negative IRP of -3.88. Are restaurants LESS risky than other industries?
Common Income Approach Models

Capitalization of Earnings
» Presumes current earnings approximate future earnings.
» Value = Earnings / Capitalization Rate

Discounted Cash Flow (DCF)
» The value of a business is the present value of all of the “benefits” it can reasonably be expected to generate in the future.
» Calculate the Net Present Value of future benefit streams.

When to DCF?
If you want to “sell the future” then DCF is the right model. But...DCF lacks meaning without solid projections. It is imperative to develop!
### Cap Earnings Case Study

**Developing the Cap Rate**

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Free Rate of Return</td>
<td>3.72%</td>
</tr>
<tr>
<td>Equity Risk Premium</td>
<td>6.12%</td>
</tr>
<tr>
<td>Small Stock Risk Premium</td>
<td>6.01%</td>
</tr>
<tr>
<td>Company Specific Risk</td>
<td>1.00%</td>
</tr>
<tr>
<td>Discount Rate</td>
<td>16.85%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Estimated Growth Rate</td>
<td>2.10%</td>
</tr>
<tr>
<td>Capitalization Rate</td>
<td>14.75%</td>
</tr>
</tbody>
</table>

**Value of Operating Company**

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Net Income</td>
<td>19,149</td>
</tr>
<tr>
<td>Capitalization Rate</td>
<td>14.75%</td>
</tr>
<tr>
<td>Indicated Value of Equity</td>
<td>129,823</td>
</tr>
</tbody>
</table>
Asset Approach

While the income and market approach are concerned with “benefit streams,” the asset approach is typically concerned with the company balance sheet at a particular time.

- Book Value
- Adjusted Book Value
- Liquidation Value

Bonus: Hybrid Method

“Backlog” Companies (like contractors, GovCons, A&E firms) can quantify value of contracts by capitalizing contracts and adding to Book Value
What's Next?
The Exit Planning Process

**Analyze**

- **Valuation**
  - Understand value now
  - Define value drivers and risk areas

- **Financial Plan**
  - What is your “Magic Number”
  - Define goals (personal, professional)

**Improve**

- **Action Plan**
  - Prioritize Areas to work on
  - Establish formal process

- **Financial Performance**
  - Increase revenues
  - Control Expenses

- **De-Risking**
  - Address risk areas
  - Improve “Sell-ability”

**Transition**

- **Prep to Transition**
  - Tax Planning and Gifting
  - Internal Succession
  - External Sale

- **Confirm**
  - Goals Same?
  - Valuation meet requirements?

- **Exit**
  - On your terms
  - On your timeline
Questions
Quantive is a business valuation practice specializing in middle market, closely held and family owned businesses.

We have over 15 years of experience in a wide range of industries.