Quantive
business valuations

Business Valuation

For the Closely Held Business

About the Presenter

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

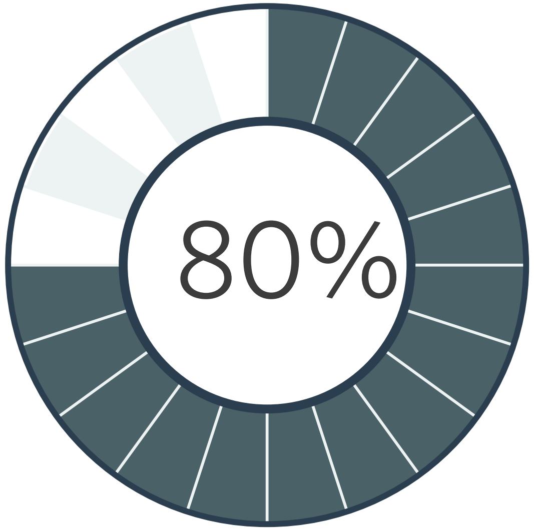
AGENDA

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

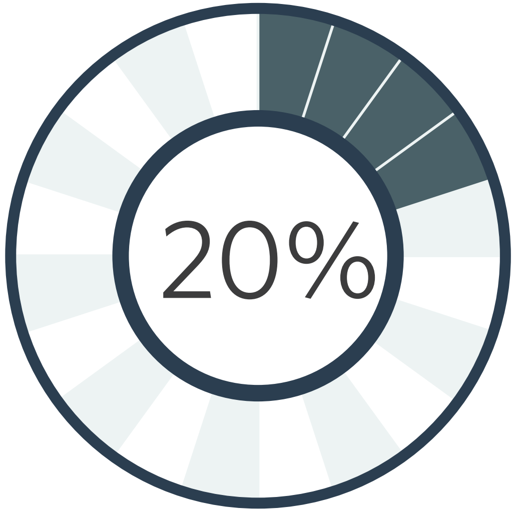
Value: Why Does it Matter?

Wealth

Retirement



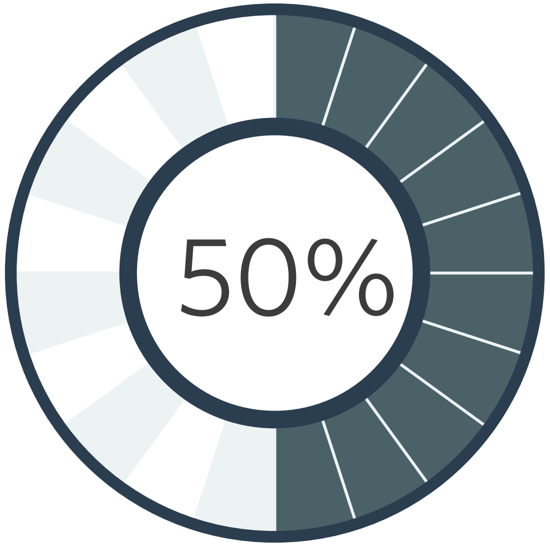
Percent of Wealth Attributable to Company Ownership



Percent of Owners With Exit Plan / Financial Plan

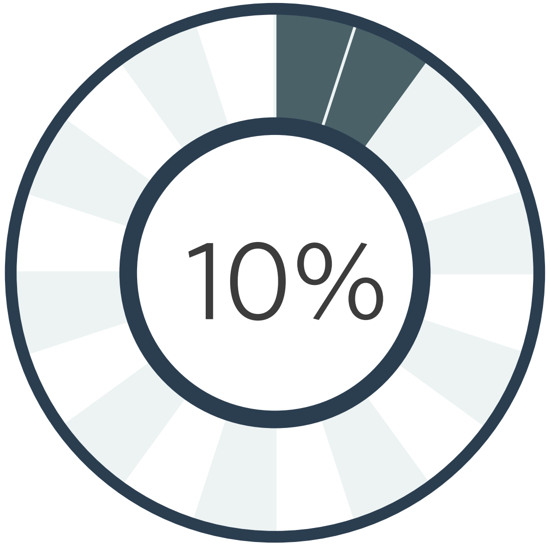
Source: Exit Planning Institute

Unlocking Wealth



Percent of Owners Intending to Exit in Next 5 Years

Achieving Success



Percent of Exits Successful on First Attempt

Barriers to Implementation

» Lack of articulation of strategies and objectives

» Insufficient KPIs

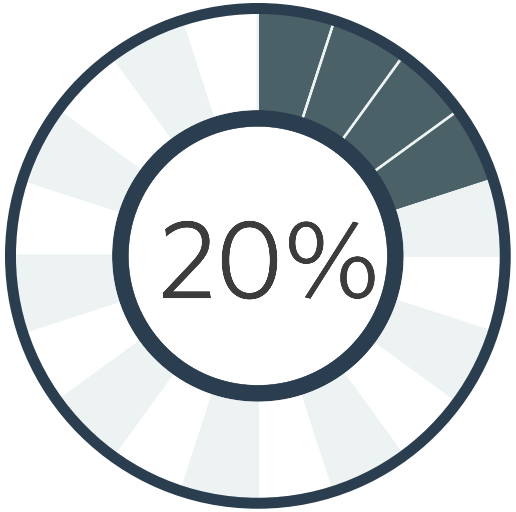
» Poorly defined tactics / not aligned with strategy

» Lacking accountability inside the organization

» No Quarterback - Disparate number of experts required in the process

» It's Difficult - Delay is easier

Take Aways



Liquid Net Worth

Funding a successful retirement from exit proceeds requires careful planning.

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

Theory that Guides Valuation

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

	FMV	FV
Willing Buyer?	Yes	Maybe
Willing Seller?	Yes	No
Compulsion to Transaction?	Neither Buyer / Seller	Maybe
Notional Parties?	Both	
Price	Equitable to both	Fairness to seller can be a consideration
Equal Knowledge of Facts	Yes	No
Discounts	Yes, DLOM and DLOC as appropriate	Generally No
Federal Tax Standard	Yes	No
Divorce, Dissenting or Oppressed Shareholder	Generally No	Generally Yes

What Drives Value

Not all widget manufacturers are the same.

Well, why not?

Risk Drivers / Value Enhancers

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

Formulas. Math. Dread.

Models, Formulas and Techniques

Standard of Value

Normalize

Model

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

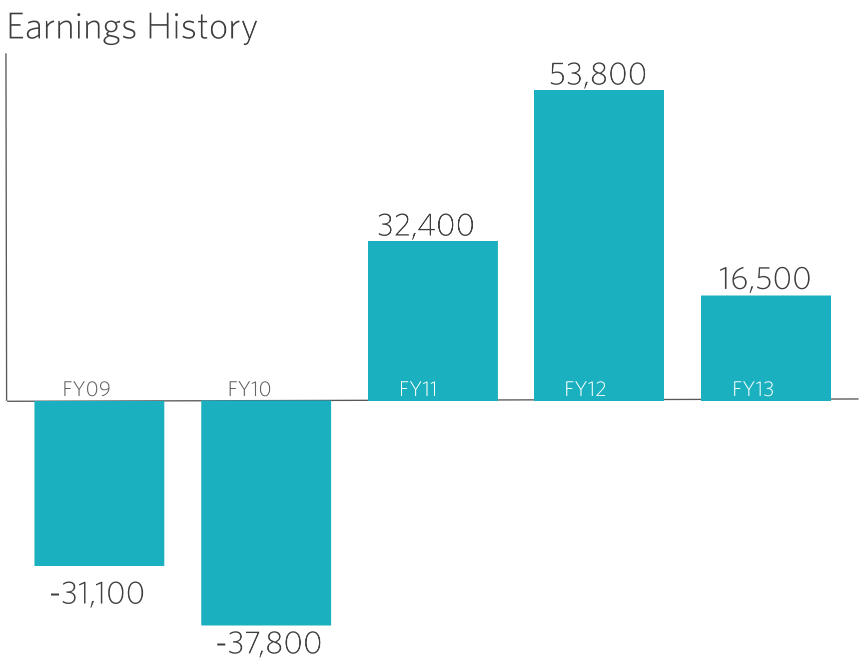
"Unusual" Examples

- 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



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?

Three Approaches

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

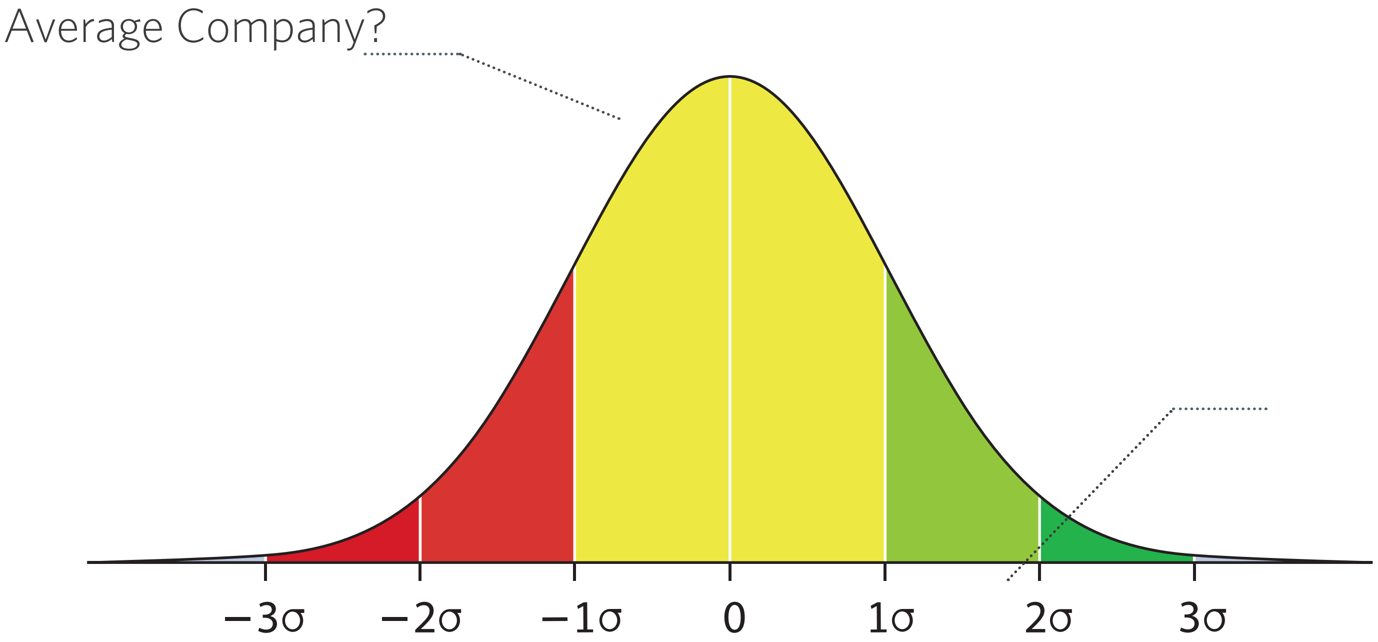
- Price / Earnings
- Price / Revenues
- Price / Gross Profit

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 <u>above</u> average.

Income Approach

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

Risk Free Rate of Return	3.72%
Equity Risk Premium	6.12%
Small Stock Risk Premium	6.01%
Company Specific Risk	1.00%
Discount Rate	16.85%
Less Estimated Growth Rate	2.10%
Capitalization Rate	14.75%

Value of Operating Company

Average Net Income	19,149
Capitalization Rate	14.75%
Indicated Value of Equity	129,823

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)

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

Improve

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.

Learn More

QuantiveValuations.com

Presenter Contact Information

Dan Doran
Dan@q-bv.com
Main: 888-827-1624
Direct: 202-734-6490