

BUSINESS VALUATIONS



THE ART
OF
BUSINESS
VALUATION

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GROWING
THE VALUE
OF
YOUR
BUSINESS

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BUY
SELL
AGREEMENTS

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Northwestern Mutual

AGENDA



THE ART OF BUSINESS VALUATION

CLOSELY-HELD COMPANIES

- Closely-Held Companies
 - Shares of which are owned by a relatively limited number of stockholders
 - Little, if any trading
 - No established market for the stock
 - Lack marketability
 - Have concentration of management in a family group
 - Influence shareholder's personal circumstances on dividend policy
 - Lack access to public markets for capital funds
 - Have greater possibility of asset realization through a merger, sale, or liquidation of the company

SITUATION REQUIRING A VALUATION


- Gift & Estate Taxes
- Fair & Enforceable Buy-Sell Agreements
- Buying & Selling Shares in the Company
- Employee Stock Ownership Plans (ESOPs)
- Corporate Dissolution
- Divorce
- Mergers & Acquisitions



DEFINING THE VALUATION ASSIGNMENT

REQUIREMENTS OF THE VALUATION ANALYST:

- Do not perform an audit
- Minimum education requirement
- Experience in subject matter
- Do use financial statements or tax returns
- Not prohibited from practice in front of IRS



DEFINING THE VALUATION ASSIGNMENT (cont.)

THREE TYPES OF REPORTS:

- Calculation report
 - Can be used as planning tool
- Summary report
 - Another planning tool; more information than the calculation
- For items going before the IRS or for litigation
 - Detailed report is necessary to address items required

DEFINITION OF VALUE: PROJECTED EARNINGS VS. HISTORICAL DATA

- Valuers may use projections for determining future earnings, or rely on historical data (or both) for determining the value of a company.
- “Fair Market Value (FMV).” FMV is defined as the price at which a business “would change hands between a willing buyer & a willing seller, neither being under a compulsion to buy or sell & both having reasonable knowledge of relevant facts.”

BASIC FACTORS AFFECTING VALUE

- Earnings
- Cash Flows
- Assets
- Gross Revenues
- Dividends
- Marketability/Liquidity of the ownership interest

ENTITY TYPES:

- C Corporation
 - Two layers of Tax
 - No preferential Capital Gains Rate
 - Classification of Personal Goodwill
- S Corporation
- Partnership
- Limited Liability Company



FINANCIAL ANALYSIS

- Provide key benchmarking ratios for the use of comparable companies
- Ratios aid the valuation analyst in adjusting for the expenses or the income generating potential of the company being appraised
- Recasting financial statements

RECASTING THE INCOME STATEMENT

- Start with the Profit & Loss Statement
- Presents the results of the operating activities over a period of time
- Net Income or Loss – the difference between revenues & expenses
- Adjustments:
 - Salaries & Perks of Owners
 - Nonrecurring expenses & income
 - Investments & non-operating expenses
 - Interest payments
 - Depreciation expense
 - Rent Expense to fair value
 - Discretionary expenses

RECASTING THE BALANCE SHEET

- Presents a snapshot of investing & financing activities (including property & debt)
- Assets (monetary & non-monetary)
 - Cash
 - Inventory
 - Property
 - Equipment
 - Accounts Receivable
- Liabilities
 - Accounts Payable, Accrued Expenses
 - Loans
- Owner's Equity
- Sample of Adjustments:
 - Assets & liabilities on the books (...& not on the books)
 - Obsolete inventory
 - Uncollectible accounts receivable
 - Loans to owners
 - Cash
 - Goodwill

RECASTING THE STATEMENT OF CASH FLOWS

- Recently the cash flow statement has been perceived “as more important than the income statement...”
- Shows inflows & outflows
 - Operating
 - Investing
 - Financing



APPROACH TO VALUATIONS

- Consider three approaches to value:
 - Asset approach
 - Market approach
 - Income approach

VALUATION METHODS

- Comparables Price
- Capitalization of Earnings
- Adjusted Book Value (Net Tangible Assets)
- Present Value of Future Income Stream
- Use of more than one method is permitted

WEIGHTING THE RESULTS

WEIGHTING THE VALUATION METHODS APPLIED:

- The weights must total 100% but cannot be randomly assigned
- The weighting scale must be justified by the appraiser
- The weights assessed by the appraiser should be based on the factors of each individual case

PREMISE OF VALUE

- Under 'Fair Market Value' normalizing adjustments are made for unusual or non-recurring items
- Under 'Investment Value' a valuation professional can make assumptions based on who the buyer is



VALUATION FOR 100% INTEREST VS. NON- CONTROLLING INTEREST

- Controlling:
 - Have control of business decisions
- Non-controlling:
 - Cannot force a sale or liquidation, set company policy, etc...

APPLICATION OF DISCOUNTS

- Discount for lack of control when valuing a non-controlling interest
- Nonvoting Discount
- Discount for lack of marketability
- Lack of marketability is applicable for both controlling interest & non-controlling interest

REVENUE
RULINGS &
CURRENT
EVENTS

SECTION 2704 –
PROPOSED VALUATION REGULATIONS

- These proposed regulations appear to limit the availability of minority interest & marketability discounts used in fair market valuations for family limited partnerships, & family controlled entities. These are proposed regulations, not effective until final regulations are approved.

ACTION STEPS FOR A VALUATION PROJECT

- Start Early:
 - Valuation must be performed by a competent professional
 - Change in valuation practice, theory & regulation is constant
- Engage specialists:
 - Certified Valuation Analysts (CVA issued by the National Association of Certified Valuation Analysts, NACVA)
 - Certified Exit Planning Advisor (CEPA issued by the Exit Planning Institute, EPI)



GROWING THE VALUE OF YOUR BUSINESS

VALUE DRIVERS –

Help you sell at a higher range
for your industry

- Look through the eyes of the buyer
- Value drivers enhance growth prospects or reduce risk of ownership
- Better performance of drivers equals higher selling price (also more earnings along the way)
- Let's look at the key value drivers



STABLE & PREDICTABLE CASH FLOW

- EBITDA – earnings before interest, taxes, depreciation & amortization. Often thought of as cash flow & multiplied by an earnings multiple by purchaser to obtain value
- Reducing the risk of losing cash flow in a transfer leads to a higher value

MANAGEMENT & PERSONNEL QUALITY

- Strong management team
- Low turnover
- Can the business run without the owner?
- Workforce experience & expertise

PROVEN BUSINESS MODEL FOR GROWTH

- Documented
- Growth potential of industry
- Additional available markets
- Cross-sell opportunities
- Can high profit margin sales be expanded?
- Can the company grow by acquisition?

DIVERSE SALES

- Low customer concentration
- Repeat sales
- Predictable sales
- Positive sales & margin trends
- Sales volume
- Cyclical or seasonal vs. steady sales
- Strong customer service



PROCESSES, SYSTEMS & PROCEDURES

- Documented & strong
- Examples:
 - Internal accounting control
 - Recruiting & retention
 - Customer acquisition
 - Quality control
 - Developed marketing strategy

RELIABLE FINANCIAL INFORMATION

- Sales reports broken out by customer, product line, sku, territory
- Detailed P&L statements with sales, cost of goods sold & margins by product or service, region or department
- Expenses assigned to profit centers
- Updated & understandable financials
- Dashboard with key performance indicators



"I think I can get us a tax credit if we start cooking the books with solar heat."

GOODWILL

- Name recognition
- Customer awareness & satisfaction
- Reputation
- Brand recognition
- Lack of legal issues

BARRIERS TO ENTRY

- Copyrights, trademarks & patents
- Trade secrets
- Proprietary designs & know-how
- Brand or trade names
- Training
- Databases
- Exclusive agreements or licenses



ASSET MANAGEMENT

- Receivable aging, collections, bad debt
- Inventory turnover
- Updated & organized equipment
- Vendor relations & concentration
- Payables days outstanding

KEY FINANCIAL DISCIPLINES

- Understand the four mission critical systems every business needs – cash flow, operations, finance & revenue
- Know your business & where cash may be hiding
- Understand debt & how to effectively use it
- Know & understand your financial strategy

KEY FINANCIAL DISCIPLINES

- Focus on cash flow from operations
- Use strategic planning & develop a budget & forecast
- Understand that not all sales are good
- Develop a firm support base of advisors



REALIZING YOUR BUSINESS VALUE

- Bo Burlingham – have a clear understanding of who you are, what you want out of your business & why (to reach your preferred outcome)
- Develop options regarding your eventual exit
- Have a vision of what you will do next



BUY SELL AGREEMENTS



DISCUSSION AGENDA

- Northwestern Mutual – A Brief Intro
- Process
- Case Study
- Other Opportunities

NORTHWESTERN MUTUAL – A BRIEF INTRO

- Northwestern Mutual has been in operation since 1857
- Has paid dividends continuously since 1872
- 330 offices serving over 3.7 million people
- \$338 billion in assets
- Enjoys the highest financial ratings of any insurance company

PROCESS

- Analyze the existing document
- Operate the agreement
- Build the team
- Implementation of the solution
- Review the outcome

CASE STUDY

- Three owners of an engineering firm
- Current buy sell formula valued the company at \$9mm
- Professional valuation put the company at \$21mm
- This disenfranchised each partner's estate by \$4mm
- Solution, re-write the agreement & purchase term insurance



OTHER OPPORTUNITIES

- Transitioning from generation 1 to generation 2
- How does your valuation play into your financial plan or estate plan as a whole?
- Key Employees – how to attract, retain & reward them

QUESTIONS?

THANK YOU FOR JOINING US TODAY!

