

Do You Know the Value of Your Business?

By: James S. Hollander

It is surprising how few business owners or general managers understand the value of their business. Two primary reasons why you should know the value of your business is first, if anyone should ever approach you with an offer to buy your business, you will have an idea of your firm's value. Secondly, and more importantly, you want to ascertain that the business strategies you pursue maximize the value of your business over time. Has the business increased or decreased in value? What has caused the value to increase or decrease?

We want our management teams to pursue strategies and business plans that enhance the value of the business. Many firms compensate their management team by measuring the increase in value they attain. The value of many businesses stagnate or decline due to a lack of strategic business planning or weak implementation of such plans. While attempting to enhance the value of your company, you also need to balance the risk of pursuing a particular strategy with the potential incremental value the strategy will likely achieve.

As a business owner or general manager, you may conclude that the value of your business would increase significantly if it were part of a larger organization that has stronger channels of distribution or the necessary capital to fund your growth. For example, the IAMs Company, which was sold to Proctor & Gamble (P&G) in 1999, has seen exceptional growth due to the marketing prowess and distribution channels of P&G. The owners of IAMs successfully secured an excellent price for their stock because they understood the synergy potential of selling the business to a company with P&G competencies.

The value of your business is a function of the cash flow it can generate and the value of the underlying assets. If your business is not generating an adequate return on the net assets employed (total assets excluding cash less current liabilities excluding short-term debt), then the value of the business will be driven by the value of its underlying net assets. In the worst case, the value will approach the orderly liquidation value of assets less any liabilities and costs to close the business.

Can a business be worth less than book value? Certainly, we find many public companies whose market capitalization is lower than the book value of the net assets employed in the business. In examining 16 Southwest Ohio public companies, we found that the overall market value of 7 of the companies was less than the book value of the net assets employed. The group possessed a median market valuation to net assets ratio of 1.1 times or a 10% premium to the book value of the net assets.

Ideally, if you consistently generate earnings that result in a strong return on net assets employed, and you have above average growth potential, the value of your business will be substantially above the book value of the net assets employed. Cintas Corporation for example, one of the 16 Ohio companies, had a market valuation 4.5 times the book value of its net assets employed due to its consistent growth and strong return net assets employed.

When people discuss the value of a business, it is necessary to understand the difference between the enterprise value and the common equity value. The enterprise value is the going concern value of the entire business. Generally, to arrive at the equity value, you need to take the enterprise value and add any excess cash or investments and subtract the market value of any debt and preferred stock.

We will discuss two methodologies to help you determine the value of your business: (1) market comparables and (2) discounted cash flow. The market comparables approach is a technique for determining value based on a direct comparison between your company and publicly traded companies in similar product lines or markets. This method examines the market capitalization rates of the financial results of public companies and applies the appropriate market capitalization rate to your company based on how your company compares to the group of public companies. In particular, the analysis focuses on the enterprise value of each public company relative to its (1) earnings before interest and taxes (EBIT), (2) earnings before interest, taxes, depreciation and amortization (EBITDA), (3) net assets employed (NAE) and, (4) net sales. The enterprise value of a public company is the market value of its common stock, preferred stock and debt less any excess cash or non-operating assets. The enterprise value relative to the various financial results (EBIT, EBITDA, NAE and Sales) are referred to as market capitalization rates or multiples.

Merger and acquisition professionals generally focus on the EBITDA capitalization rate because it normalizes the different depreciation methods between companies. You want to compare your company's performance with the comparison group to determine what capitalization rate to use. If for example, the median for the group was 5.5 times EBITDA, and your company's performance in terms of margins and growth was similar to the group; you would likely apply an EBITDA multiple close to the median, or possibly below, because your company is private and is likely smaller than the public companies.

Prior to applying the appropriate market capitalization rate, you need to adjust your historical EBITDA results to remove the effects of non-recurring extraordinary items and excess compensation paid to shareholders. Applying an adjusted market capitalization statistic against the adjusted EBITDA gives you the enterprise value of the business. For example if your adjusted EBITDA is \$1.2 million and you determine, after looking at the comparison group, 5.0 times would be a reasonable EBITDA multiple, then the business has a *enterprise value* of \$6.0 million.

To determine the *equity value* of the business, the enterprise value is reduced for the market value of any financial debt, off-balance liabilities, and other long-term liabilities. It is also increased for the market value of any cash, investments and non-operating assets.

The discounted cash flow approach ("DCF Approach") is better suited to help you evaluate the implications of pursuing various growth strategies and an illustration of XYZ Company has been provided to help you understand the mechanics of this approach. This method utilizes historical financial data and expectations in the industry and develops a scenario of expected annual free cash flows that would be realized over a period of time. These free cash flows and a residual value are present valued at a market cost of capital or discount rate to arrive at an enterprise

value. The value of the equity is determined by subtracting the market value of the debt and any other non-operating liabilities and adding the market value of excess cash, investments and non-operating assets. In the illustration of XYZ Company, the enterprise value of the business is \$5.9 million and the equity value of the business is \$4.4 million.

The two key factors affecting the DCF Approach are (1) the projected free cash flows available to shareholders and (2) the required rate of return to discount these projected free cash flows to present value (discount rate). Free cash flows are derived from the projected financial statements resulting from your business and strategic plans. They are generally 5-10 year projections. The free cash flow is the amount of cash that is available each year after meeting capital expenditure and working capital needs of the business. This free cash flow is what would be used to pay debt, dividends, and excess owners compensations. Free cash flow should be adjusted to eliminate interest expense or interest income.

In addition to the annual free cash flow, the company has a value at the end of the projection period that is called the residual value. The residual value is equal to the free cash flow in the last year projected divided by the discount rate less the long-term growth rate. The implication of this calculation is the business will continue to generate this cash flow forever, which may not be appropriate in certain situations. To be conservative, many assume no growth beyond the last projection year, but that would severely penalize the value of a high growth company.

The discount rate or cost of capital is the required rate of return investors would want to invest in a company like yours. It allows us to determine what those future free cash flows and residual value are worth today. If you wanted a 10% annual return on your investment, what would you pay to receive \$110 in one year – answer \$100. Without going into a lot of financial theory, it is generally safe to assume a discount rate of 10% -15%. As the risk associated with the cash flows increases, higher discount rates should be used to calculate the present value of the annual free cash flows and residual value. The discount rate is also impacted by the amount of debt you can safely use to finance the business.

It is important to develop a framework to understand the value of your business and the implications of pursuing your business plans. After you have developed your valuation model, it is wise to review and discuss it with a professional familiar with valuation theory. Once you have a model, you will be able to measure the value of your business over time.

One final note of caution, in situations where you will be valuing the business for estate planning purposes and stock transfer among family members, you should secure a valuation from an independent professional appraiser who will provide the detailed documentation necessary to meet IRS valuation guidelines.

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Company XYZ
Illustration of Discounted Cash Flow Valuation
(\$000's)

	<u>Actual</u>	<u>Projected</u>				
	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
<u>Income Statement</u>						
Sales	\$ 10,000	\$ 10,300	\$ 10,609	\$ 10,927	\$ 11,255	\$ 11,593
EBITDA	1,200	1,236	1,273	1,311	1,351	1,391
Depreciation and Amortization	<u>150</u>	<u>164</u>	<u>180</u>	<u>196</u>	<u>213</u>	<u>231</u>
EBIT	1,050	1,072	1,093	1,115	1,137	1,160
Interest Expense	<u>105</u>	<u>104</u>	<u>85</u>	<u>64</u>	<u>41</u>	<u>15</u>
Pretax Income	945	968	1,008	1,051	1,097	1,145
Income Taxes	<u>378</u>	<u>387</u>	<u>403</u>	<u>420</u>	<u>439</u>	<u>458</u>
Net Income	<u>\$ 567</u>	<u>\$ 581</u>	<u>\$ 605</u>	<u>\$ 631</u>	<u>\$ 658</u>	<u>\$ 687</u>
EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization						
EBIT = Earnings Before Interest and Taxes						
<u>Balance Sheet</u>						
Accounts Receivable	\$ 1,250	\$ 1,288	\$ 1,326	\$ 1,366	\$ 1,407	\$ 1,449
Inventory	<u>1,500</u>	<u>1,545</u>	<u>1,591</u>	<u>1,639</u>	<u>1,688</u>	<u>1,739</u>
Current Assets	2,750	2,833	2,917	3,005	3,095	3,188
Net Property, Plant & Equipment	<u>1,500</u>	<u>1,542</u>	<u>1,574</u>	<u>1,597</u>	<u>1,609</u>	<u>1,609</u>
Total Assets	<u>\$ 4,250</u>	<u>\$ 4,374</u>	<u>\$ 4,491</u>	<u>\$ 4,602</u>	<u>\$ 4,704</u>	<u>\$ 4,797</u>
Accounts Payable	\$ 500	\$ 515	\$ 530	\$ 546	\$ 563	\$ 580
Accrued Expenses	<u>300</u>	<u>309</u>	<u>318</u>	<u>328</u>	<u>338</u>	<u>348</u>
Current Liabilities	800	824	849	874	900	927
Debt (Cash)	1,500	1,269	1,007	711	379	9
Stockholder's Equity	<u>1,950</u>	<u>2,281</u>	<u>2,635</u>	<u>3,016</u>	<u>3,424</u>	<u>3,861</u>
	<u>\$ 4,250</u>	<u>\$ 4,374</u>	<u>\$ 4,491</u>	<u>\$ 4,602</u>	<u>\$ 4,704</u>	<u>\$ 4,797</u>
Return on Equity	29%	25%	23%	21%	19%	18%
Dividends	250	250	250	250	250	250
<u>Cash Flow</u>						
Net Income		\$ 581	\$ 605	\$ 631	\$ 658	\$ 687
Depreciation		164	180	196	213	231
Capital Expenditures		(206)	(212)	(219)	(225)	(232)
Change In Working Capital		<u>(59)</u>	<u>(60)</u>	<u>(62)</u>	<u>(64)</u>	<u>(66)</u>
Annual Cash Flow		481	512	546	582	621
Adjustment For Interest Expense*		<u>62</u>	<u>51</u>	<u>39</u>	<u>25</u>	<u>9</u>
Free Cash Flow		<u>\$ 543</u>	<u>\$ 563</u>	<u>\$ 585</u>	<u>\$ 607</u>	<u>\$ 629</u>
Cumulative Free Cash Flow		\$ 543	\$ 1,106	\$ 1,691	\$ 2,297	\$ 2,927
<u>Discounted Cash Flow Valuation</u>						
Present Value of Free Cash Flows		\$ 2,147				
Present Value of Residual Value		<u>3,736</u>			Residual Value**	\$ 6,295
Enterprise Value		<u>5,882</u>				
Plus: Excess Cash in Year 0		-			Discount Rate	11%
Less: Debt in Year 0		<u>1,500</u>			Long-Term Growth Rate	1%
Equity Value of Business		<u>\$ 4,382</u>				

* Interest Expense times (1 minus the tax rate)

** Free cash flow in Year 5 divided by (11% - 1%)