Legacy M&A Advisors LLC

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The Methods Behind a Valuation Part II

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Introduction

Last month we discussed The Comparables Price Method, The Capitalization of Earnings Method, and the Net Tangible Asset method of business valuation. This month we go on to discuss additional methods that are used and weighted in order to arrive at a valid and reliable valuation.

Present Value of Future Income Stream (Leverage Cash Flow Debt Method

A variation of the capitalization of earnings method is referred to as the "Leveraged Debt Concept." This concept takes into consideration the fact that an outside party may leverage an acquisition of the current company and use all of the income to pay the interest on borrowed money. Currently the cash flow method is becoming more important in valuations as companies tend to "free cash", I.e. earnings before interest, taxes, depreciation, and amortization. (EBITDA)

Excess Earnings Capacity (Goodwill)

This method is based on the theory that the value of a company is equal to the value of the net tangible assets plus the value of excess earnings (e.g.., goodwill, patents, trademarks, copyrights, etc.). Eight factors are typically considered when calculating goodwill: age of the company, employee turnover, the value of the suppliers and the products sold, market area, potential growth, inventory efficiency, company location, and banking relationships. Excess earnings attributable to intangible assets are the foundation of the value of goodwill. Once this calculation is made, the result is added to the adjusted asset value as identified alone in the Asset Approach.

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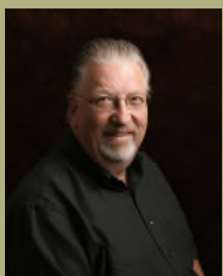

Mike Ertel is a Certified M & A Advisor and a Principal Broker with Legacy M&A Advisors, LLC, a full-service M & A Advisory firm with an office in Tampa, Florida specializing in representing sellers and buyers of small- to mid-sized companies. Prior to joining Legacy M&A Advisors, LLC, Mike's business career spanned 30+ years with Fortune 500 and Fortune 1000 Companies, with senior management roles in Marketing, Operations and Logistics. Mike also served as President, COO of a mid-sized Manufacturing company headquartered in Tampa. Mike also holds a BS in Electrical Engineering and an MS in Industrial Administration, both from Purdue.

A CASE STUDY

Reasonable Compensation

A Court of Appeals recently reversed a Tax Court holding involving reasonable compensation to a key stockholder/employee of a privately held corporation. In many situations, a high salary can be justified by having special expertise to operate the business. In the present situation, the Court of Appeals stated that reasonable compensation should also take into consideration prior years of being undercompensated by the company. In the case at issue, the corporation's gross revenue increased tremendously over the past several years. However, only recently did the stockholder/employee begin to receive compensation.

The stockholder actually took out 4.4 million dollars in compensation in one year. Obviously, the IRS, as well as the Tax Court, held that such compensation was unrealistic and unreasonable.

The Court of Appeals stated that the individual, being the only stockholder of the corporation, had worked long and hard to get to a point where he could receive a lot of money. Accordingly, the amount of compensation i.e. 4.4 million dollars represented the amount needed to remedy many prior years of being undercompensated in building the business. Thus, the Court of Appeals ruled that the salary paid to the sole stockholder was not unreasonable

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CoverStory

Net Income Residual Approach or Dividend Paying Capacity

This method looks at the income that is left over for the stockholders as it relates to a company's return on investment. Effectively, it can be referred to as the ability of the company to pay dividends to the stockholders using income that is not needed to operate the business in the future. Dividends are based on earnings after taxes as they relate to investment (stockholder's equity) at the beginning of the year. Dividends represent the after-tax earnings that are distributed to the stockholder instead of being kept in retained earnings to help finance future projects. This is a key method to determining what an investor would pay for participating in the operations of a privately held company.

Terminal Value

In theory, purchasing a business is comparable to purchasing a corporate bond. When the bond is purchased, the corporation or governing entity pays the holder interest for the stated term of the bond usually in 6 month increments or so. At the end of the term of the bond, the holder is repaid the value of the bond.

A business, on the other hand, operates in much the same manner, or at least it should. Upon purchase of the business, the owner benefits from the activity of the business and either draws or is paid some kind of distribution or dividend (depending on the type of entity). Though obtained in a different manner, these payments are similar to the interest paid in a bond. Upon retirement, death or exiting the business, the business owner is entitled to the fair value of the business (similar to cash in value of the bond) including a terminal value. While it is not paid out automatically, the terminal value may be obtainable through sale of the company to the next person.

Often, the terminal value, adds more than 50% to the value of a business. This is the same with corporate bonds. Often, if the value of a bond is broken down, the income stream is worth 25 – 40%, while the residual value is worth 60 - 75% of the bonds value.

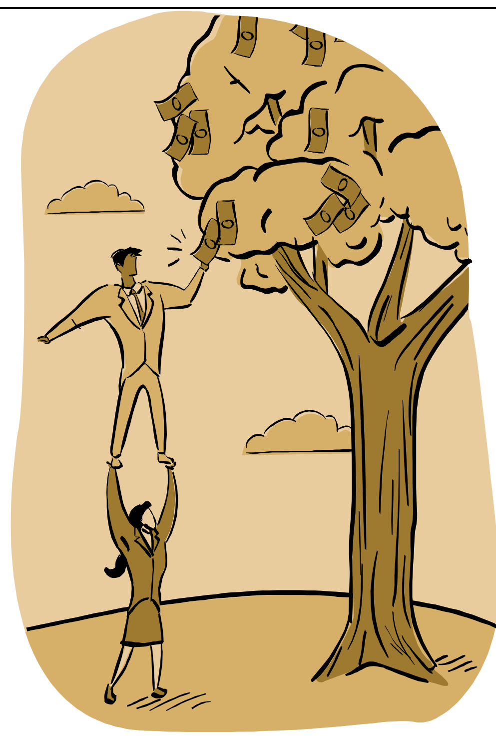
Conclusion

Next month, we will discuss Year End Tax Planning. Tax Planning this year saves Tax Paying Grief next year!

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

Points of Interest

- **This month we go on to discuss additional methods that are used and weighted in order to arrive at a valid and reliable valuation.**
- **Currently the cash flow method is becoming more important in valuations as companies tend to “free cash”, I.e. earnings before interest, taxes, depreciation, and amortization. (EBITDA)**
- **Often, the terminal value, adds more than 50% to the value of a business.**



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A CASE STUDY CONTINUED:

<u>Editorial Comments</u>: This case is fantastic for anyone involved in trying to build a business. In many situations, individuals start a business and rely on savings, as well as a spouse's income, to be able to put their business on its feet. The Appeals Court clearly stated that, as long as an individual worked hard and was undercompensated in the past, there was nothing wrong with receiving a large salary in one year (in the present case 4.4 million dollars) to make up for the years of being undercompensated.

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<u>Beyond EBITDA - 5 Other Factors That Affect How Private Equity Buyers Value Your Company</u>

Prospect Partners is one of the largest and most active private equity buyers focused on acquiring companies with revenues of >$10M but <$75M. In September they released an article with this same title, and I thought it was so well done I'm reprinting the highlights here. <u>If you'd like a copy of the complete article, contact me and I'll send it to you</u>.

It is no secret private equity firms are focused on the bottom line. Profit margins, EBITDA, and growth all impact the value of a business. However, objective measures aren't the only drivers of valuation. Here's a look at five subjective variables that play roles in how investors value smaller companies because of their potential future impact on the business.

1. ***Who Runs The Shop ... And How Well?***
   - *How deep is the team?*
   - *Is there a succession plan?*
   - *Has the owner invested in people in the key areas of the business?*
2. ***What Does The Market Look Like?***
   - *Is the business growing faster or slower than its market?*
   - *How is growth being driven?*
   - *Is growth sustainable?*
3. ***What About Concentrations?***
   - *Relationship concentration?*
   - *Market segment concentration?*
4. ***How "Full" Is The Business?***
   - *The building?*
   - *The equipment?*
5. ***Are There Any Human Resources Concerns?***
   - *Health insurance issues?*
   - *Employee documentation in order?*
   - *Minimum wage impact?*
   - *Labor pool availability?*

Again, <u>if you'd like a copy of the complete article, contact me and I'll get it to you</u>.

As ever, if you know of a business owner who's thinking of selling or buying a business and who might benefit from a ***free***, ***confidential***, consultation with us, have them contact me directly.

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Frequently Asked Questions…

Q When I sell my business, what assets can I expect to keep in the transaction?

A: When a business is sold, the asset purchase agreement dictates which assets are sold and which assets are kept by the seller. Typically, the cash and accounts receivables are not sold along with the other assets as the seller keeps these in order to pay outstanding debts of the business and provide the buyer with free and clear ownership. It must be remembered that an asset sale means the corporate structure is still in existence and may have to be dissolved after the sale.

Q: I am interested in selling my business, but I do not have children and my key employees are looking to go elsewhere. What should a business owner do in this situation?

A: The best thing to do in this situation is to not panic and do something reckless like sell the assets at a low value. Most businesses have some intrinsic value within them. At a minimum, an advisor should be consulted in order to get the best possible value for the business. In this situation, 1) the key employee and employer should consider entering into a mutually beneficial employment contract, and 2) a written plan should be developed, with the key employee, as to how to proceed to grow and develop the business.

Q: Even though it is mid-year, is there any tax or business advice for the business owner that would be worthwhile for the current tax year?

No matter what time of the year it is, there is always an opportunity to be gained through business and tax planning. The subject of which will be discussed in the next newsletter.