Valuations

One of the more important services that the investment banker provides, is to provide analysis and render an opinion of the value of the corporate enterprise. Most assignments that Grand Avenue Capital work involve the determination of value. A number of techniques are utilized to determine the value of the enterprise, and clients understand that in the final analysis, the true value of the business is the **market.** It is important to note that accurate data on market valuations of private companies and private company M&A transactions are often illusory or not easily determined. It is critical therefore, to establish quantitative assessments of value from an experienced investment banking firm or valuation firm and to critically evaluate these estimates with the expectations of the shareholders.

Most investment bankers will not prejudice the counterparty with a specified valuation, given that synergies and valuation metrics may not be known to the banker. Likewise it is important to determine in the client's valuation expectation is consistent with the banker's experience and market knowledge.

Valuation Methodologies

No single methodology is universally applicable in determining the fair market value of a business. A complete and objective business valuation which looks at and compares a number of methods is generally the *starting point* for sellers and buyers of on-going businesses. Armed with a professional opinion of value using several different analyses will give the shareholders a better understanding of the merits of offers that may be received by buyers. **In the final analysis, it is the market that will dictate the value**; i.e. ***the price and terms that a business will transfer between a willing buyer and seller, when neither is under any compulsion to buy or sell, and both parties have access to all relevant facts and understanding of the business being sold.***

Of primary importance in determination of value, it is critical to assess the future prospects of the enterprise. While historical financial performance is a valuable starting point, future performance will ultimately validate the value today for the entity. The valuation analyst must also assess the operation of the company **today** and make a call with input from the client regarding what the **future** revenues, costs, capital expenditures, working capital requirements, industry competitive threats, technology changes and other opportunities and impediments face the company. Acquiring companies who fail to risk-adjust each of these internal and external factors of company performance increase the likelihood of failure in their acquisition strategy.

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Several valuation methodologies will be briefly discussed here for completeness with commonly known valuation practices. These include:

1. Present value of unlevered future cash flows and related analyses
2. Various cost approaches
3. Market values from closed transactions and data from publicly traded companies
4. IRS Rev. Rul. 68-609/Rev. Rul 59-60, et al

It is important to note that business valuations have many purposes. The aim here is the true value from a financial prospective of the on-going business in a merger/acquisition transaction. Other valuation purposes may include legal proceedings, disputes between shareholders or partners, estate planning and resolution, ESOP regulations, and capital raising. Analysts calculating values in these latter areas may have different objectives in determining value.

Frequently promulgated are "rules of thumb" earnings or EBITDA multiples to determine value. These are proxies of value simplifying either a more rigorous analysis or summarizing what transactions have actually occurred in the market. It is our opinion that sole use of these proxies is dangerous; clearly, analysis of the internal (company specific) and external (industry specific) factors of valuations discussed below need to be understood to fully understand the value of a specific enterprise. The use of the multiples is pervasive, however.

Present Value of Unlevered Future Cash Flows

A rigorous analysis of the present value of the unlevered, after tax future cash flows, less working capital and CAPEX requirements, discounted at the cost of capital is considered the financially accurate and correct estimate of business enterprise value. Such an analysis is performed twice: the first values the firm in the hands of the present shareholders, employing the cost of capital of the firm, with business as usual factors incorporated into the forecast of unlevered cash flows.

The second analysis starts with the first and overlays what, if any synergies (positive, but also negative) are brought to the firm by the acquirer, with the cost of capital of the acquirer estimated as an element of synergy. A range of values is therefore established which will bracket price negotiations between buyer and seller.

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The financial analyst utilizing this present value formula for determining enterprise value takes into account:

- Analysis of the existing business, margins, costs, revenues, and operating factors.

- Analysis of current financial condition of the company, balance sheet strengths or weaknesses, debt capacity, operations capacity utilization, marketing strengths or impediments to growth and capital needs.

- An analysis of the exogenous factors in the industry, macro-economic factors, domestic and offshore competitive threats and opportunities, customer trends, etc.

- The impact is assessed of these external trends on the forecast of future revenues, costs, after tax cash flows without existing leverage and after capital needs based on management’s best estimates of working capital and capital expenditures.

- An important element here is to scrub the line items of the profit / loss statement. Expenses classified as "business" related may often not be and these non-business owner expenses need to be added back to determine the true earning power of the business.

- A determination is made of the weighted average cost of capital of the firm and the present value of these after-tax unlevered cash flows is calculated. An assumption is made regarding terminal value, and excess working capital (if present and not required in the business) is added to the present value. The present value calculation is made for the existing shareholder case and the case of the company owned by the acquirer.

- Proforma, post-acquisition financials of the acquirer are prepared with assumed acquisition financing to pressure-test the valuation assumptions. If the acquirer is able to finance the acquisition with an acceptable blend of equity and debt as dictated by current market conditions, and on a proforma basis the acquired company indicates an acceptable return on the acquirer’s equity, the valuation has positive validation.

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Cost Approaches to Valuation

Various cost-based methodologies are employed, and briefly discussed here. Because these methods generally ignore the earnings generating capabilities of the firm, these methods are discounted in terms of the value of the ***on-going concern value***.

- **Replacement cost approach**: Typically this method is important in a "make vs. buy" decision and focuses on assets only. Rather than acquiring a company, the acquirer determines that the replacement cost of the target's assets are much lower than the target's on-going business value. It ignores, for instance, the value of the target's intangibles as position in the market or market share, value of a highly trained workforce and experienced management, unique relations with customers or vendors, value of intellectual property and trade secrets, etc.

- **Adjusted Asset cost approach**: The balance sheet of the target can be adjusted to reflect current market values of assets and liabilities. This is an appropriate method for valuing a real estate holding company or limited partnership interest, but not helpful in determining the on-going value of a stream of cash flows from an operating company.

- **Book Value approach:** The accounting book value of an enterprise determined from the accumulated retained earnings is generally used to compare acquisition values to a benchmark book value. This does not provide a true indication of the market value of the enterprise, nor does this take into account the free cash flow that can be generated by the enterprise.

- **Appraisal value:**

  The difference between the appraised value of the assets and the historical cost liabilities gives a value that is useful in liquidation or bankruptcy scenarios. Again this value has little relevance to the on-going value of the business enterprise.

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Market Valuation Data Applied to the Target Company

Obtaining actual market data on closed transactions and applying this data to a target company is a indispensable measure of market value agreed to by a willing buyer and seller. Information on transaction between ***public*** companies is readily available; however, data on typically ***private*** smaller firms is difficult to obtain, and even analysts who follow a particular industry have difficulty in making direct analogies between private company deals.

Not surprisingly, however, such data on **private** companies, when obtained, is a compelling metric when determining and negotiating the value of the target company. What is often not known, but overlooked, is data relative to comparisons of product mix, unique vendor relationships giving rise to differential costing, management impact on performance, market share, size, proprietary and differential technical capabilities, trade secrets and other intellectual property, etc. Unfortunately, market comparable data for operating companies are misused and overused, *particularly when few data points are available*. Market comps are better utilized in the real estate industry, and used equipment markets.

Public markets are generally considered efficient in valuing companies. Daily stock prices reflect the value assessment of many buyers and sellers. Public company data is considered a valuable benchmark in valuing on-going entities. Each comparable company's data (EBITDA % of sales, gross margin % of sales, etc.) is compared to the target company's metrics and the target's value is determined by relatively weighting the metrics of the number of public companies in the sample.

Market actual data, however, is another set of information available to the informed acquirer who relies principally on the present value techniques described above. Public-to-Private discounts are applied, as well as discounts for size of the enterprises, and will give some guidance as to the valuation of the private company.

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Excess Earnings approaches (IRS Rev. Rul 68-609/59-60)

The IRS has weighed in with methodology that it suggests being used only when no better basis is available for valuing the intangible assets of a business using a "formula" approach. Fortunately, the science of financial analysis has progressed too minimize the use of this methodology in conventional M & A transactions.

This formula approach suggests that the average annual return on the ***tangible*** assets is deducted from average total earnings of the company and the remainder, if any is considered to be the amount of the average annual earnings from the ***intangible*** assets. This latter amount is capitalized by a percentage of 15-20%, and the former capitalized at 8-10%. Lower factors are utilized for stable companies with low risk; higher factors are utilized for companies in which the hazards of business are relatively high.

The Revenue Rulings suggest that the past earnings to which the formula is applied should fairly reflect the probable future earnings.

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