VIEWPOINT ON VALUE

SEPTEMBER/OCTOBER 2016

Deal of a lifetime
Market a business to maximize its selling price

Define it before you assign it
A business interest can have many different levels of value

Spotlight on the market approach

Relying on management's estimates of expected cash flow

Deal of a lifetime

Market a business to maximize its selling price

When it's time to sell, how a private business is marketed can have a significant impact on the cash available for distribution to owners. For many private investors, their business interests are their primary assets, so their livelihoods often depend on receiving top dollar.

Hot market

2015 was a record-breaking year for mergers and acquisitions. U.S. deal volume topped $2.1 trillion, and the momentum is expected to continue — and trickle down to smaller companies. The hottest industries include technology, health care, financial services, and oil and gas.

Business sellers should beware, however, that some opportunistic buyers are looking for deep bargains. So it's important to price your company with the help of an experienced valuation professional using current market data. Failure to achieve a full value for the company can lead to seller's remorse or lawsuits from minority shareholders who dissent to the sale.

Asking price

When setting the asking price for a business, it's tempting to rely on industry rules of thumb. For example, folklore in the manufacturing industry might indicate that a manufacturing company will sell for three to five times earnings.

These pricing multiples are simple, but they're also ambiguous, which can lead sellers to under- or overestimate how much their business is worth. The example provided leaves many unanswered questions, including:

- What does the term "earnings" mean?
- Where within (or outside of) the three-to-five range does a specific company fit?
- What does the formula include or exclude?
- Do you need to subtract debt or add working capital to arrive at the value of the business?

Comparable, real-world transactions provide a much more meaningful indication of how much the company is worth in today's volatile marketplace than rules of thumb. Valuation professionals can help find a sample of "guideline" transactions. Then they can convert these guideline transactions into relevant pricing multiples that can withstand scrutiny from minority shareholders who may question the deal.

If comparable transactions aren't available, the seller may need to perform a discounted cash flow analysis to arrive at the asking price. An outside professional can help calculate a reasonable discount rate based on market evidence, estimate the company's expected cash flows and make discretionary cash flow adjustments, if necessary.

Buyer's perspective

Once sellers establish the asking price, it's time to solicit potential buyers. Whether they're private equity firms, venture capitalists or closely held competitors, prospective buyers will intensely scrutinize business operations and financial results. It's important for sellers to maintain bargaining power during due diligence by doing their homework *before* putting the business on the market.

This means the seller needs to consider the buyer's perspective and compile a package of information for buyers to review. Gather such documents as the last five years of financial statements, business plans, forecasts and projections, marketing collateral, and contracts with customers, suppliers, subcontractors and

key employees. Buyers are also likely to ask questions about tax issues, operating risks, and potential threats such as litigation — and sellers should be ready with the answers.

By planning ahead for buyers' information requests, sellers appear prepared, experienced and credible, thereby expediting the due diligence process. Doing so also allows the seller to cast the presentation of financial and operational information in the most favorable light. They can, for example, play up factors that enhance value and minimize the need for financial statement adjustments, which tend to turn off prospective buyers. In some cases, a seller may decide to settle lawsuits, divest unprofitable business lines or buy out minority shareholders in anticipation of a sale.

Deal structure

Last but certainly not least, sellers need to think about deal structure and tax issues in advance. In general, sellers tend to prefer stock deals, rather than asset sales, from a tax perspective. However, buyers generally prefer asset sales, which allow them to cherry-pick the most desirable assets and exclude the seller's liabilities. Installment

sales, earnouts, and postdeal consulting and noncompete agreements are additional issues to address before negotiating with prospective buyers.

By planning ahead, sellers can identify problems and take action to enhance the company's value. An outside valuation professional can help "market" a for-sale business to maximize its value to selling shareholders. ■

Open season for online equity crowdfunding

In May, the Securities and Exchange Commission's (SEC's) equity crowdfunding rules went into effect. So far, the market response has been tempered, as start-ups and other small businesses try to navigate the rules and determine whether the benefits outweigh the costs.

The new guidelines allow private companies to sell shares to investors regardless of wealth or income as long as the company has submitted annual financial reports to the SEC. Those reports must be audited for offerings of more than $500,000.

Other restrictions apply. For example, a company can raise only up to $1 million through SEC-approved online crowdfunding portals. The SEC also limits how much individual investors can contribute via crowdfunding in any 12-month period based on their net worth and annual income.

These restrictions make equity crowdfunding more complicated and costly. Congress is currently contemplating legislation that would simplify the rules. If enacted, simpler guidance could help equity crowdfunding become more widely accepted as a method of financing for private businesses.

Define it before you assign it

A business interest can have many different levels of value

Control and marketability are two key issues when valuing a private business interest. Most investors will pay more for a business interest that possesses elements of control, such as the rights to declare dividends and liquidate assets. They also tend to prefer investments that sell with relative ease and certainty.

Before your valuation expert starts gathering information to value a business, an important question must first be answered: What's the appropriate "level of value" based on the purpose of the appraisal and the characteristics of the ownership interest? Here's what you need to know to find the answer.

Elements of control

The most valuable level is generally a company's value on a controlling basis. Potential buyers typically are willing to pay more for a controlling interest than for a minority interest. The key to arriving at a control value is to make discretionary adjustments to the company's cash flow, such as adjusting for above- or below-market-related party transactions or owners' compensation.

Control value can be broken down further into 1) strategic and financial control value or 2) public and private control value. But appraisers don't always agree on these classifications. The difference between strategic and financial control is the expected synergies available to a strategic buyer. Strategic buyers often pay a premium over financial buyers.

Public and private merger-and-acquisition (M&A) methods generate cash-equivalent control values. Some valuators contend that controlling interests take time and resources to sell and, therefore, may warrant an illiquidity discount — regardless of whether they're based on public or private transactions. No empirical studies exist, however, that directly quantify such discounts for controlling interests.

Value as if publicly traded

In the middle of the levels of value chart is the subject company's minority, marketable value. Minority shareholders who can't control day-to-day business operations sometimes are unwilling to pay as much per share as controlling

shareholders. Rather than take a discrete discount for lack of control, valuators typically arrive at a minority level of value by abstaining from making discretionary adjustments to cash flow.

Because professional management teams of public companies typically try to maximize earnings per share, their financial statements may require few or no discretionary adjustments. Assuming controlling shareholders don't abuse their discretion (as may be the case with a public company), the pro rata share of a public company's value on a controlling basis closely approximates the value of shares on a minority, marketable basis. In other words, there's little to no discount for lack of control in these cases.

Conversely, marketability refers to how quickly and easily shares can be converted to cash. For example, shares of Apple Inc. are sold on the New York Stock Exchange and can be bought or sold simply by calling an investment advisor or trading online. Marketability is worth something to investors. Both the guideline public company method and the income approach can generate a marketable value, because they're based on public stock data.

Last and usually least

Finally, there's minority, nonmarketable value. Many appraisal assignments call for the value of a minority interest in a private company. This is generally the least valuable of the levels and is difficult to estimate directly, except by using previous arm's-length transactions of the subject company's stock. But previous transactions may not exist — or, if they do, they may not be relevant.

The typical starting point for this level of value is a minority, marketable value, as described previously. From there, a lack of marketability discount is taken. Sources of empirical data for marketability discounts include restricted stock and pre–initial public offering (pre-IPO) studies.

Managed expectations

The differences in value from one level to the next can be significant — often 20% or more. So, it's critical to define the appropriate level of value upfront. Doing so minimizes potential disputes, errors and gaps between the conclusions of opposing appraisal experts. ■

Spotlight on the market approach

There are three general ways to value a business: the cost, income and market approaches. Here we compare and contrast two methods that fall under the market approach.

Overview

When valuators use the market approach, they typically compute pricing multiples. These compare the prices paid in comparable, real-world transactions to some performance metric, such as revenue, cash flow or operating income. These pricing multiples are then applied to the same performance metric of the subject company to estimate its value.

To illustrate, a valuator may generate a median price-to-net income multiple of five times based on comparable (or "guideline") transaction data. If the subject company's net income is $5 million, its preliminary equity value would be $25 million. From here, various adjustments and discounts may still be required to arrive at a value consistent with the appropriate basis and standard of value.

M&A method

Under the merger and acquisition (M&A) method, valuators evaluate sales of entire businesses. Private companies aren't required to report the details of their sales, but valuation professionals subscribe to various transaction databases that track this information. In recent years, private transaction data has become more widely available and detailed as the business valuation discipline has matured and the M&A market has become increasingly active in some industries.

One downfall of this method is the perceived reliability of the data. Some M&A transactions may not represent fair market value, especially if the parties were related, a financially distressed seller was compelled to liquidate his or her interest, or a strategic buyer paid a synergistic premium to gain market share. These details may not be ascertainable from transaction data in the databases, which contain only limited information about the deals.

When applying the M&A method, valuators analyze the details of comparables and understand the nuances of each transaction database used. For example, valuators consider whether each comparable is an asset or stock deal and determine what was included in the sale, such as receivables, inventory, fixed assets and debt. Adjustments may be needed to make apples-to-apples comparisons.

The M&A method generally results in a controlling value. So, a discount sometimes is needed to value the interest on a minority basis.

Guideline public company method

Alternatively, under the guideline public company method, valuators derive pricing multiples from prices paid for stocks in publicly traded companies that operate in the same or similar lines of business. This method can be difficult to apply to small businesses that operate as "pure players" in a single industry, because many public companies are conglomerates that participate in multiple industries and are generally much larger than private companies.

When comparable public stock data is available, it can generate a reliable valuation metric, especially if the guideline public stocks are traded actively, the subject company is large enough to trade on the public markets and the assignment calls for a minority basis of value. Because of its perceived objectivity, this method is often preferred by courts and the IRS — as well as when estimating fair value under U.S. Generally Accepted Accounting Principles.

To use or not to use

Valuators *consider* the market approach in every appraisal engagement. But they don't always rely on either M&A data or public stock prices to arrive at their final conclusions. Sometimes there are too few true comparables — or none at all — within a reasonable time frame. Other times, there's too much variation in the transaction data to provide a meaningful pricing multiple.

Your valuator will address these methods and explain why they're included in (or excluded from) his or her analysis. Doing so will help you and others who rely on the report understand the expert's mindset. It also prevents outsiders from assuming that methods were merely overlooked. ■

Relying on management's estimates of expected cash flow

Often, business valuations are based on estimates of expected cash flow made by the company's management. Even when a valuator or the company's CPA prepares the estimate, it's often based on management's representations about the company's future plans about market opportunities and potential threats. So, it's important to evaluate whether expected cash flow seems reasonable — or whether the estimate is overly optimistic or pessimistic.

Fundamental building block

Suppose a valuator has two recent estimates of net cash flow to choose from:

1. Equity net cash flow of $5 million based on a *projection* the company's owner prepared to apply for financing the construction of a new plant, or

2. Equity net cash flow of $4 million based on a *forecast* prepared by the company's CPA in accordance with the AICPA attestation standards.

If a valuator applies a 20% equity capitalization rate to both estimates, the resulting values would be $25 million ($5 million divided by 20%) and $20 million ($4 million divided by 20%). In other words, if the valuator uses the projection rather than the forecast, every $1 of additional net cash flow results in an extra $5 of value at a 20% cap rate.

Forecast vs. projection

Which of these two hypothetical estimates is appropriate? When evaluating cash flow estimates, it's important to understand the difference between the terms "forecast" and "projection."

The AICPA defines forecasts as prospective financial statements that present, to the best of management's knowledge and belief, an entity's expected financial position, results of operations and cash flows. A financial forecast is based on assumptions reflecting the conditions management expects to exist and the course of action management expects to take.

It defines projections as prospective financial statements that present, to the best of management's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations and cash flows. Projections may present a hypothetical course of action for evaluation.

Valuators generally use forecasts — that is, expected results based on the expected course of action — when appraising private business investments. Projections are sometimes used, however, when calculating economic damages, determining fair value in a shareholder dispute or evaluating capital budgeting decisions. The date of and reason for preparing the estimate also can impact its relevance.

Name that estimate

It's perfectly acceptable for valuators to rely on an estimate of expected cash flow that's prepared by the company's management. But it's important to understand the type of estimate that was created. Small differences in expected cash flow can have a big impact on the value of a business. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. In addition, any discounts are used for illustrative purposes and do not purport to be specific recommendations. ©2016 VVso16