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Valuation Report

Business Valuation Trends and Strategies

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Transaction Strategies

Understanding Investment Value and Synergies in a Sale

When it comes to selling a business, the big question in the owner's mind is simple: "What's it worth?" And as any valuation professional will tell you, the answer is, "Whatever the buyer will pay for it."

Of course, this type of exchange is frustrating for a business owner seeking quick, hard-number guidance on value. But it's important to remember that value is a somewhat imprecise term. Value depends on the circumstances surrounding the business, its cash flow, financial position, competitive situation, management team and many other factors.

And in every case, value also depends on the buyer's goals and what the business can provide for that individual or entity.

Standards of Value

Valuations done for the purposes of transactions are generally based on fair market value (FMV). As a reminder, fair market value is defined by IRS Revenue Ruling 59-60 as "the amount at which the property would exchange hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

FMV doesn't assume a specific buyer: It assumes a *market* of buyers. And while FMV is perhaps the most common standard of value, it is not the only one. For example, fair value is often used in cases of minority shareholder disputes, and intrinsic value is often used relative to the valuation of option pricing.

The standard of value of interest to many buyers and sellers — even if they don't know it by name — is investment value. Unlike FMV, investment value is defined as the value to a particular investor.

In other words, while FMV is what valuation guru Shannon Pratt describes as "impartial and detached," investment value represents value based on individual investment requirements and expected earnings and monetary return to that specific investor.

It would be rare for a valuation professional to issue a formal valuation report for a transaction based on investment value. However, this is often how sellers envision the value of their businesses — in a sale to a specific buyer who will pay more than FMV due to how much the company will enhance the buyer's income or existing portfolio.

Synergy Doesn't Change FMV

According to Pratt, investment value is often different from fair market value for one of four reasons:

1. Differences in assessments of future earning power.
2. Differences in perception of the degree of risk.
3. Differences in tax status.
4. Synergies with other operations owned or controlled.

While the first three reasons are often relatively straightforward for valuation analysts to assess and quantify, the fourth reason is a bit more elusive in terms of dollar amount.

Synergies — or a synergistic value — assumes that the acquisi-

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What's the Relationship Between Debt and Value?

Businesses generally run on two types of capital: debt and equity. Debt is expected to be paid back to the lender with interest. Equity is the funding provided by owners or shareholders in the form of a capital investment, which may be "paid back" in the form of dividends or sale.

Valuation analysts use several ways to assess the impact of debt. Perhaps the most common is through the cost of capital, which assesses the cost of all funds used to finance the business. It gives debt and equity proportional weight to arrive at an overall weighted average cost of capital (WACC).

WACC reflects the return expected by lenders and investors. It may also be applied as the discount rate used in a discounted cash flow calculation to determine the company's net present value.

It's at this point where debt and value intersect. An increase in WACC means an increase in risk, which translates to a decrease in value.

Determining the Nature of Debt

With this in mind, it's obvious that debt can influence valuation because of its associated risk. For example, a company with a large amount of debt may not be able to meet its repayment obligations if sales slip. Another risk is that inflation will negate or erode the purchasing power of the loan.

So how does a valuation analyst assess the risk associated with a company's debt in calculating the cost of capital? In a recent presentation to the AICPA, author and valuation specialist Larry Cook suggested that analyzing debt requires assessing both the obvious and the hidden costs, as well as the nature of the debt itself.

Cook explained that obvious considerations include the debt's interest rate, terms and collateral. Hidden costs include expenses such as origination fees; legal, accounting and valuation fees; loan covenants; and personal guarantees, including collateral, liens and pledges.

Cook also suggests asking the following questions to assess the nature of the debt:

- Is it interest bearing? Is it documented?
- Have payments been made? Will payments ever be made?
- How long has the debt been carried? How long has the company had a line of credit balance? How long has the company carried credit card debt?

Answers to these questions give the valuation analyst an indication of the level of risk associated with the debt.

What about Covenants and Guarantees?

Cook points out that loan covenants and personal guarantees can impact the costs associated with borrowing and therefore the cost of capital.

Loan covenants require the borrower to meet certain financial benchmarks and ratios — they stay within certain financial parameters during the life of the loan. Once a covenant is broken, the lender has the right to call the loan. So generally, the more restrictive the covenants, the more risk is involved.

Similarly, it's not unusual for lenders to ask an owner to personally guarantee debt, using his or her personal assets as collateral. A personal guarantee is intended to decrease the risk of default, but it clearly ties the company's financial health to the owner's financial health.

Given the complexities involved in assessing debt and its impact on value, it is imperative that owners, investors and other interested parties rely on the opinion of an experienced valuation analyst.

Want to know more about debt and value? Contact us today for further insights.

Transaction Strategies: Investment Value and Synergies

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tion target will complement and augment an existing business enough to justify a price that's higher than fair market value. The idea is that with a synergistic acquisition, competitors or companies in the same industry may be able to fill a desired product or service niche, sales channel or market void, or leverage existing research and development.

The problem is that synergies are often overvalued — most often by the seller but sometimes also by the buyer. And synergy doesn't change FMV. While the seller may have better luck negotiating a slightly higher value if there are synergies involved — and should certainly play up synergies in the sales pitch — synergies typically don't change the valuation landscape to the extent the seller anticipates or desires.

Getting Real About Synergies

To arrive at synergistic value, a typical valuation practice would be to build the synergies into a discounted cash flow (DCF) analysis. This would consider the cash flows the target company would provide for a typical (non-synergistic) buyer versus a synergistic buyer and project a price from those calculations.

But some analysts believe that this methodology is flawed because it tends to overestimate the synergistic cash flows and underestimate the risks involved. Also, it often misses the mark on the division of value between the seller and the buyer.

One solution to this problem is undertaking two separate valuations. The first would be a typical FMV/DCF valuation based on cash flows to a typical buyer. The second would be a separate valuation of the synergies and the discounted cash flows associated with them. The second valuation would generally have a higher discount rate to reflect the higher risk of actualizing the value of the synergies after acquisition.

Note that the valuation of the synergies involves several fine points. For example, adjustments must be made to the cash flows associated with acquiring or paying the salaries of a full management team, which may or may not be necessary with a synergistic buyer.

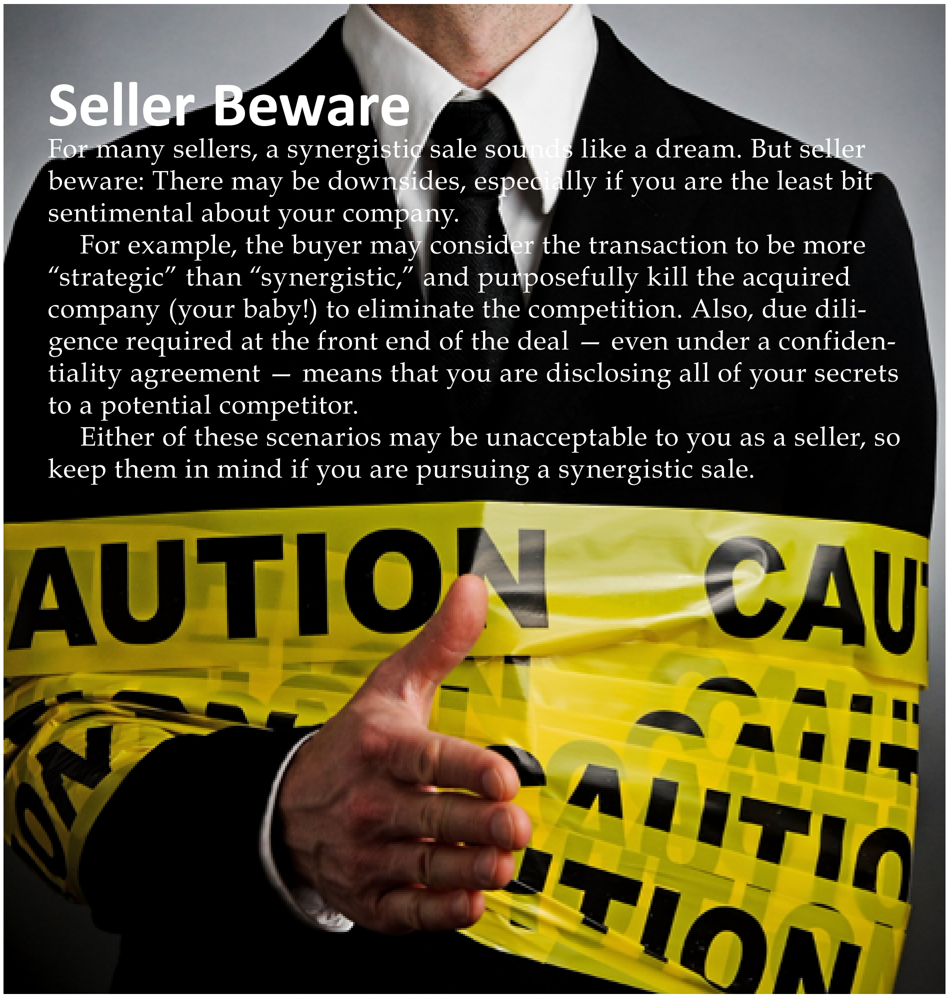
After all of these adjustments are made, adding the synergy value to the FMV will generally result in a more reasonable picture of the synergistic deal.

Selling and Buying Strategically

If you are considering a sale to a synergistic buyer, it's important to realistically discuss with your financial advisors and valuation professionals the potentially higher value the synergies might deliver to a specific buyer or set of buyers. It's also crucial that you refine the presentation of your company to showcase those synergies and how they make your company more valuable.

Of course, if you are on the other side of the deal — as a buyer — it's imperative that you carefully consider the synergies you envision and realistically estimate the time it will take you to realize the additional value. It often takes much longer than initially expected to fully integrate the acquired company's assets, operations and sales efforts in a way that fully exploits the synergies you've paid for.

Our valuation team is well versed in the details of synergistic value. Contact us today to discuss your specific questions.



Seller Beware

For many sellers, a synergistic sale sounds like a dream. But seller beware: There may be downsides, especially if you are the least bit sentimental about your company.

For example, the buyer may consider the transaction to be more "strategic" than "synergistic," and purposefully kill the acquired company (your baby!) to eliminate the competition. Also, due diligence required at the front end of the deal — even under a confidentiality agreement — means that you are disclosing all of your secrets to a potential competitor.

Either of these scenarios may be unacceptable to you as a seller, so keep them in mind if you are pursuing a synergistic sale.

Considerations When Valuing a Carve-Out

When a smaller company is created from a larger one, the new entity — known as a carve-out — can create valuation challenges. Carve-outs often have complex relationships with their former parent company or other affiliates, and sometimes it's hard to get a clear picture of what the new company comprises.

Consider these potential tangles that must be unraveled:

What are you valuing? The answer often depends on the purpose of the valuation. For example, if the valuation is for a transaction, what precisely is being sold? If it's an existing division, the valuation might not be so complicated. But if a new entity is being put together for sale, it's a different story.

It may be necessary to look at it from a buyer's point of view: What would a prospective owner want or need to operate the carve-out as a viable business? Sometimes it takes careful analysis to provide a valuation for a new entity, especially if it's currently not run as a stand-alone.

What's included? Operations, employees, assets and liabilities must be allocated to the carve-out. The cost of replacing shared functions and economies must also be defined and quantified.

What about inter-company dealings? Often, businesses with the same parent do business with each other: One might be a customer of or supplier to others, for example. If that is the case, the valuation must reflect the risks involved in keeping or losing those arrangements. Similarly, pricing of goods or services may change once the carve-out is no longer related to the other associated companies.

What about taxes? Related companies sometimes arrange transactions in a way that is intended to reduce tax liabilities. Figuring out the "real" cost of doing business is essential to an appropriate valuation.

Prepare to discuss these and other issues with your valuation analyst when considering a carve-out.