Merger & Acquisition Focus

June/July 2005

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The market, income and asset approaches to valuation

It's not difficult to determine the value of a publicly held company: Simply multiply its current share price by the number of shares outstanding. Calculating the value of a closely held company, on the other hand, can be quite complicated. It usually involves in-depth analysis of a business's income statements, balance sheets and tax returns, and takes into account other factors such as economic and industry conditions.

To value a closely held business, valuation experts generally use one of three general methodologies: the market, income or asset approach. Which one they choose depends on the type of business being valued, its historical operating performance and its prospects for future earnings.

Market approach

The market approach determines value based on what informed and rational capital market investors might pay to own stock in a company. Valuation experts compare a closely held company with publicly traded companies that are comparable in size, operations, products, customers, diversification, markets, capital structure and regulatory environment. Accurately selecting guideline companies is critical to the success of the market method.

Once guideline companies are identified, the appraiser multiplies the closely held company's financial data, such as earnings or book value, by the public company's market multiples to arrive at a value. Then the appraiser subtracts the fair market value of the company's interest-bearing debt to determine the fair market value of the company's equity.

The usefulness of the market approach depends largely on the amount and quality of data the valuation expert has been able to obtain about publicly traded companies. It's challenging to apply this valuation approach to businesses with no publicly traded peers such as professional practices or companies with unusual products. It may also be hard to apply the method to companies that depend heavily on intellectual property and patents.

Income approach

The income or cash flow method is a more appropriate way to value companies with unusual niches and few comparable companies. With the income method, valuation experts use normalized historical earnings or cash flows to estimate a business's value based on its ability to generate future income.

To normalize the business's financial statements, appraisers analyze each line item and decide whether it represents a continuing expense, or whether it's atypical and unlikely to

Normalizing financial statements

The potential for future cash flow — determined by analyzing past cash flow — is generally the most important element in a business valuation. Appraisers, therefore, must start with accurate historical financial data.

They improve the quality of historical data by adjusting or normalizing financial statements. This might be performed for various reasons, including:

Excess cash. A company might have excess cash relative to the funding needs of current operations. So the appraiser will add this excess cash to the company's value.

Nonrecurring expenses. Unusual or one-time items, such as moving expenses, are not likely to affect a company's value in the future. This type of expense can be added back to a company's earnings.

Owner compensation. Owners are often more highly compensated than other members of management. If a business is going to be sold, an appraiser might adjust earnings to reflect the lower cost of future management compensation.

recur in the future. If the item is nonrecurring, it's removed from valuation consideration. Failure to normalize assets can result in a distorted picture of the company's assets.

The valuation expert must also choose an appropriate capitalization rate — a measure of the amount of risk-adjusted return an investor requires to invest in a company. The capitalization rate is a function of interest rates and equity risk. Capitalization rates are generally higher for more speculative businesses, though they vary over time. The average long-term growth rate is also factored into the capitalization rate.

Finally, the appraiser divides the company's income stream by the capitalization rate to reach a value for the business.

Asset approach

The asset approach values a company by adjusting the accounting value of assets and liabilities to their tangible fair market values. This approach employs the principle of substitution, which assumes a prudent buyer will pay no more for an asset than the cost of replacing it with an equally desirable substitute.

Most companies' balance sheets are prepared according to generally accepted accounting principles (GAAP), which records assets and liabilities at their original acquisition price. But by relying on historical cost, GAAP does not account for appreciation or depreciation over time. Many balance sheets, therefore, fail to represent a company's fair market value.

The asset approach to valuation uses a GAAP-prepared balance sheet only as a starting point. The balances in the asset and liability accounts are revalued depending on whether the business is a going concern or in financial distress. For this reason, the asset approach is commonly used to value companies in bankruptcy, where the value of the company as a going concern can be compared to its liquidation value.

Assets and liability accounts can be valued individually, item by item, or collectively, by major categories. All, however, are valued according to the same standard of value — whether it's fair market value or some form of liquidation value. In addition to balance sheet items, appraisers consider nonrecorded assets and liabilities including intangible assets, liabilities for warranties, and contingencies.

The fair market value of current and long-term liabilities is then identified and subtracted from the fair market value of the business's assets in order to quantify the fair market value of the firm's equity.

Value of the valuation process

Valuing your business is an important step in preparing it for sale because it provides a basis from which to begin your deal's negotiations. Even if you aren't ready to sell now, the valuation process will focus your attention on the aspects of your business that create the greatest value and involve the greatest risk.

Timing the sale of your business

In a perfect world, business owners sell their companies when banks are anxious to lend, the economy is strong, their industry is booming and the business is enjoying record profitability, with the future looking even brighter. Naturally, a perfect convergence of all of these variables would enable you to maximize the value of your business — allowing you to sell it at the highest price and on the best terms.

But most business owners don't sell when market conditions are perfect. Instead, they make the decision for more personal reasons, such as to retire or to free up cash to pursue other investment opportunities. Unfortunately, many businesses are sold when the owner dies unexpectedly or is otherwise unable to run the business. These unplanned events increase the chance that the business will realize a lower selling price than it would in better circumstances.

Questions to ask

Before you make the decision to sell, you need to ask yourself several questions. First, how motivated are you to sell? Selling a business is an arduous process that can take a year or more from the initial valuation to finding a buyer to finalizing the deal.

> *Even if you have no current plans to sell, managing your company as if it will be sold is likely to result in a more efficient, financially viable business.*

Second, have you adequately prepared your business to be sold? Most experts agree that owners should plan for the sale of their business at least three years in advance. You may even want to plan for an eventual sale as you're still establishing and building your business.

But even if you have no current plans to sell, managing your company as if it will be sold is likely to result in a more efficient, financially viable business. For example,

your business plan — whether a formal or informal document — should evaluate growth opportunities, market position, and business goals, and explain how progress in reaching these goals will be measured. Not only is your business plan an important tool in unlocking the current value in your company, but it also serves as an initial prospectus for prospective buyers.

Internal and external factors

Keeping an eye on economic cycles and how they affect the merger and acquisition market is important. The market for privately owned companies can be just as cyclical as that for publicly traded companies. Economic recessions, for example, generally mean there are fewer buyers. General economic weakness can also result in a drop in your business's profitability and a perception among buyers that your business is a risky acquisition.

Also be aware of your business's growth cycle and plan to sell when sales growth has reached a peak. Of course, this isn't always easy to calculate, and typically requires the help of outside advisors. Further, you are better positioned to sell if your company boasts valuable patents, brands, proprietary products or a lucrative market niche.

Businesses are typically valued on a multiple of earnings. Your business's earnings, therefore, must be transparent and documented. Many deals are funded with bank debt, and most lenders won't finance a transaction without stable cash flows that can be verified through an audit. Buyers also

usually look for breadth of management because it reduces the company's dependence on the departing owner and allows the buyer to learn the business from an experienced management team.

There are also a number of relatively minor things you can do to enhance the perceived value of your company and make it more attractive to purchasers. Cleaning up and organizing office, factory and warehouse spaces is an inexpensive enhancement. Repairing or replacing equipment may cost a bit more, but will help you attract buyers seeking a turnkey operation. Finally, consider disposing of unproductive assets or old inventory that buyers don't want to be burdened with.

Maximizing your selling price

Selling your business can be a time-consuming and complex process, but you're likely to maximize your selling price by planning the event well in advance and by engaging qualified advisors to assist you. While a deal can often be put together quickly, maximizing value means that selling your business may take time. Remember, you don't want to feel pressured to take the first bid, or to accept terms that are less than favorable.

Achieve liquidity *and* retain control with a leveraged recap

A leveraged recapitalization can be a creative way to obtain liquidity without selling your business. Leveraged recaps involve converting an owner's or shareholder's equity position to debt and then using the proceeds to purchase stock or pay a dividend.

How does it work?

Leveraged recaps can be structured in one of two ways. The first is by selling a significant portion of an owner's equity (typically between 60% and 80%) in a business to a private equity group. The private equity group uses a combination of cash from its general investment fund and bank debt to finance the transaction.

Alternatively, company shareholders borrow money — typically from a bank — and use the proceeds to purchase the selling owner's or shareholder's stock, or to pay an extraordinary dividend to shareholders. In either case, existing shareholders realize liquidity from their stock holdings while retaining a meaningful equity position in the company. This means they may have additional opportunities to sell company stock or earn dividends in the future.

As with any major transaction, several critical ingredients make a leveraged recap successful. A company should have a strong management team willing to invest significant equity in the business and, if necessary, to personally guarantee bank debt. The business should also boast a history of profitability, realistic growth opportunities, predictable cash flows, an underleveraged balance sheet and adequate collateral.

What are the benefits?

The main advantage of leveraged recaps is that they can help you achieve diversification by liquefying a portion of your otherwise illiquid equity, allowing you to pursue

other investment opportunities. Yet by retaining an ownership position, you can still provide continuity for your family business, preserve its culture and protect the jobs of valued employees.

The potential to sell remaining shares at some point in the future, combined with the dividend paid at the time of the leveraged recap, can actually make a business more valuable.

This type of financing can also be used to:

- Transfer a family business from one generation to the next while providing the funds necessary to cover tax liabilities,
- Generate liquidity for meeting capital expenditure requirements and foster growth, and
- Buy out select shareholders.

The potential to sell remaining shares at some point in the future, combined with the dividend paid at the time of the leveraged recap, can actually make a business more valuable than if you had sold it outright. Furthermore, a leveraged recap enables you to offer ownership opportunities to your management team and enjoy watching the company reach its full potential.

What are the pitfalls?

Before you pursue a leveraged recap, however, you should realize that these deals can potentially hurt your company. While each deal is different, businesses using this form of financing become more highly leveraged. This means that even relatively low-risk companies can become higher risk overnight.

What's more, management is generally personally responsible for repaying any senior debt. And owners hoping to raise cash should realize that, with a leveraged recap, they won't necessarily receive all of the proceeds in that form.

There are also special concerns for companies partnering with a private equity group. Private equity groups typically expect to generate an internal rate of return of 25% on their investment and their time horizon is relatively short — between five and seven years.

Is now the time?

Following some weakness in the early part of this decade, private equity group and lending activity is picking up. Now is a relatively good time, therefore, to pursue a leveraged recap deal.

Owners considering this option, however, must be committed to the business following the transaction (especially when the business is facing a crisis, or during economic or market-related downturns). Otherwise, new investors may shy away, fearing that existing shareholders no longer have an incentive to create long-term shareholder value.

Q. What is a letter of intent and how does it work?

A. When a bid is made for a company, a letter of intent (LOI) formally acknowledges the buyer's proposal. An LOI is an important first step in reaching a negotiated agreement between a buyer and a seller. It lays out the general terms of the proposed deal and allows the buyer to make its significant positions clear. This can help save time and minimize ambiguity as the transaction progresses.

LOIs may be short and to the point, or lengthy and more detailed. A more detailed LOI may be worth the extra time and effort, as it can mitigate the risk of a canceled transaction during a deal's final stages because important provisions of the final contract have already been set forth. Even so, a short LOI is better than none at all.

At the very least, an LOI should outline several major issues regarding a proposed acquisition. These include:

- A purchase price or estimated price range,
- A description of the business, including a list of assets to be transferred,
- Seller responsibilities, such as making records available to the buyer,
- Current liabilities, including taxes, and which party will be responsible for them, and
- The basic structure of the deal, including payment terms and whether it will be a stock or asset sale.

The LOI should also address key conditions that must be met before a final agreement can be executed. For example, buyers typically require that sellers satisfy legal and financial due diligence before the deal closes. Depending on the buyer, adequate financing might also need to be secured.

The LOI may further state that, if a definitive contract is not signed by a certain date, the contract is null and void. It may also indicate whether the negotiations between the parties are exclusive and for what period of time.

Agreements for exclusive negotiations are almost always legally binding on sellers. Not surprisingly, when sellers agree to exclusive negotiations, they generally try to limit the exclusivity period. That way, they are free to entertain other offers if a deal is not reached by the end of the period. Buyers, on the other hand, generally prefer exclusive negotiation provisions — and for longer periods — because they provide leverage in later deal negotiations.

To be a valid and enforceable agreement, an LOI must contain certain legal provisions. In a general sense, however, an LOI is not enforceable as a contract. It simply summarizes the major terms and conditions of a transaction that will be subject to additional — often significant — amounts of due diligence.

Always consult an attorney to either draft or review your LOI. Your attorney's oversight will help ensure it includes the provisions you desire, without committing you to undesirable terms.

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