Business Valuation
A presentation for Manitoba Learning Match 2014

February 11, 2014

Daniel Bernard, CA, CBV
J.P. Barnabé, CA
Overview

- When to get a Valuation
- Valuation Reports
- Basic Principles of Valuation
- Common Methodologies
- Value Drivers and Detractors
- Goodwill
- Fair Market Value and Price
Reasons for a Valuation

- Buying/selling all or a partial interest of a business
- Mergers
- Organizational recapitalization or restructuring
- Estate planning
- Financial reporting
- General information purposes
- Assist in settlement of shareholder disputes
- Corporate or partnership dissolution
- Divorce
- Dissenting shareholder oppression suits
Levels of Valuation Reports

- **Calculation of Value**
  - Generally not suitable for litigation
  - Used for preliminary assessment for litigation
  - May be suitable for shareholder disputes depending on requirements of shareholder agreement
  - Used commonly for estate planning, reorganizations, and general information purposes

- **Estimate of Value**
  - Suitable for litigation in most cases
  - Used commonly when clients are looking for more assurance over the value

- **Comprehensive Valuation**
  - Highest Level
  - Suitable for any situation
Basic Principals of Valuation

- Value is prospective
- Value is determined at a point in time
- Commercial vs. non-commercial goodwill
- Market drives the required rate of return
- Value is usually driven by earnings/cash flows, only occasionally by liquidation value
- Higher the TAB, the lower the risk
- Minority interests usually worth less than ratable value
Fair Market Value

The highest price available in an open and unrestricted market between informed and prudent parties, acting at arm’s length and under no compulsion to act, expressed in terms of money or money’s worth.
Price Versus Fair Market Value

The fair market value of a business as determined in a valuation report and the price the business could be sold for can be different:

- **Fair Market Value** is the starting point and determined in a ‘notional’ market place
- **Price** is the end result
- **Price** is determined after exposure to the open market, negotiation between the parties, who are at transacting at arm’s length
## Business Valuation

### FMV and price is driven by

- Earnings/cash flow
- Multiple
  - Specific to the company
  - Previous transactions in the industry
- Assets
  - Working capital
  - Property plant and equipment

### Price is driven by

- Consideration
  - Cash
  - Vendor take back
  - Contingent consideration
- Synergies (Net economic value added)
  - Benefits of synergies may be shared
- Other factors
  - Emotions
  - Negotiating abilities
  - Etc.
Common Ways to Value a Company

Three approaches to valuation

1. Asset based approach (real estate, earning not sufficient to support asset)
   - Liquidation value (orderly and forced)
   - Adjusted net book value - adjusting tangible assets/liabilities to FMV “no goodwill”

2. Future based returns approach
   - Capitalization of net earnings - steady and predictable earnings
   - Capitalization of cash flows (EBITDA)
   - Discounted cash flows - fluctuating earnings - high growth

3. Market based approach
   - Comparable transactions
Valuation Approaches

Overview of Valuation Approaches

Is the Business Enterprise a viable entity?

YES

Going Concern Approach

- Future Based Returns Approach
- Market Approach
- Asset-Based Approach

NO

Liquidation Approach

- Asset-Based Methodology
  - Orderly vs. forced
Valuation Approaches and Methods - Going Concern Approaches

Going Concern Approach

- Income
  - Capitalized Earnings
  - Capitalized Cash Flow
  - Discounted Cash Flow

- Market
  - Comparable Public Companies
  - Comparable Transactions
  - Rules of Thumb

- Asset
  - Adjusted Net Book Value

Discounted Cash Flow

Rules of Thumb
Earnings/Cash Flow Based Method

Overview

The most commonly adopted earnings/cash flow based methods are:

- Capitalization of normalized net earnings;
- Capitalization of normalized after-tax discretionary net cash flow;
- Capitalization of normalized earnings before interest and income taxes (EBIT);
- Capitalization of normalized earnings before interest, income taxes, depreciation and amortization (EBITDA); and
- Discounting of discretionary cash flows (DCF).
Earnings/Cash Flow Based Method

Selection of Method

Capitalization of Earnings/Cash Flow Method
Generally, the capitalization earnings/cash flow method is appropriate for:
- A mature business with relatively consistent earnings/cash flow;
- A business where average earnings/cash flow can be reasonably estimated throughout a business cycle; and
- A business for which forecasts are not available or are not reliable.
Earnings/Cash Flow Based Method

Selection of Method (continued)

Maintainable Earnings/Cash Flow from Operations
An estimate of maintainable (indicated) earnings requires the valuator to have an understanding of the relevant economic, industry and business factors and the historical, current and prospective financial position and operating results of the business. To determine maintainable earnings cash flow:

- Adjust historical earnings for a three to five-year period for any non-recurring amounts and reflect all transactions as if they had been at arm’s length. Some of these adjustments may include:
  - Economic market salary adjustments (owner/manager - Bonus out to keep SBD);
  - Adjustments for non-recurring revenue and expense items;
  - Adjustments for non-arm’s length transactions at uneconomic rates;
Earnings/Cash Flow Based Method

Selection of Method (continued)

Maintainable Earnings/Cash Flow from Operations (continued)

- Adjustments for revenues and expenses related to redundant assets (discussed below);
- Leverage adjustments (if using equity earnings/cash flows);
- Adjustments for non-recurring start-up costs; and
- Other issues - several divisions operating under one corporation, economies of scale, etc.

- Select maintainable earnings based on historical and expected trends.
- May also consider budget/forecast if available.
Earnings/Cash Flow Based Method

Selection of Method (continued)

Discounted Cash Flow Method
- The DCF method is often applied in situations where:
  - The business has a finite life;
  - The business is forecast to experience change for a number of years before achieving a sustainable operating level; and
  - Start-up company.

The components of the DCF method are similar in many respects to those of the capitalization of discretionary cash flow method.
## Value Drivers and Detractors

### Value Drivers

| + Consistent and predictable revenue and earnings |
| + Unique market position (patents/technology) |
| + Diverse and high quality customers |
| + Limited offshore competition |
| + Significant barriers of entry |
| + Strong competitive position - market leader |
| + Strong industry M&A activity |
| + You have something unique/competitive |

### Value Detractors

| - Customer concentration |
| - Supplier dependence |
| - Open to offshore competition |
| - Lack management depth |
| - Limited market potential |
| - High cost to expand |
| - High capital expenditures |
| - High fixed cost creating risks |
| - Limited buyers |
| - Major competitors |
| - Geographic concentration |
**Example of EBITDA method**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normalized EBITDA (A)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>EBITDA Multiple (B)</td>
<td>4 X</td>
</tr>
<tr>
<td>Enterprise value (A x B = C)</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Less interest bearing long-term debt</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Total Equity Value</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Tangible assets</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>
Capitalization Rate / Multiplier

Risk is normally initially estimated in rate of return or percentage terms (“Capitalization Rate”) and then converted into a Multiplier.

- Observable equity market data is usually expressed in percentage terms.
- The bank charges you “interest” not a “multiplier”

The purpose of the Multiplier is to convert a stream of future cash flows into a single capital sum, “capitalized value” or “present value”.
Capitalization Rate / Multiplier

The Capitalization Rate most commonly used is referred to as a “Weighted Average Cost of Capital” or a blended return the debtors and shareholders of a business would demand/require to compensate them for the risks of investing in the company’s securities.

A Weighted Average Cost of Capital is comprised of three main parts:
• Estimate cost of equity (difficult)
• Estimate cost of debt (easier)
• Ideal capital structure of debt vs equity
Capitalization Rate / Multiplier

The selection of a capitalization rate is dependent on an analysis of the strengths, weaknesses, opportunities and threats faced by a particular business and considering its future prospects.

The rate selected considers many factors, but most importantly, it needs to realistically reflect business risk and the risks of achieving expected cash flows.

The Capitalization Rate and Expected Future Cash Flows are inter-related and cannot be determined in isolation.
Tangible Asset Backing

- Tangible Asset Backing is a measure of the base of net assets required to operate a business, i.e. net operating assets.

- It is a risk measure to a purchaser; it provides an approximation of the recoverable funds if the business fails after purchase.
Tangible Asset Backing

• The calculation of TAB starts with restating a business’s assets and liabilities to their respective estimated fair market values.

• Often, the amounts reported for accounting purposes are not reflective of the real economic value of the asset or liability. Examples:
  • Land and Building purchased in 1980 recorded at historical cost
  • Debt financing received from family members at 2% interest rate
Tangible Asset Backing

• TAB involves a review of the balance sheet to determine if there are “Redundant” Assets or Liabilities.
• Redundant Assets are excess assets which do not influence, and could be removed, without affecting ongoing operations. Examples:
  • Excess cash or investments
  • Personal vehicles
  • A cabin property located by Invermere, BC
  • A boat
  • Others?

• Redundant Assets and Liabilities are removed when estimating TAB, however they are included in the final valuation conclusion.
Goodwill

When valuing a business, a valuator will consider the potential sources of goodwill (often a qualitative analysis) and if they are consistent with the goodwill implied by the valuation conclusion (a quantitative measure).
Goodwill

During the analysis of goodwill, a valuator must carefully consider whether goodwill is commercial or personal.

- Commercial goodwill is sellable (transferable), e.g. location, service, product
- Personal goodwill is not sellable (non-transferable), e.g. value to owner, owner’s special skills and relationships
Goodwill

A buyer will pay for goodwill that can be transferred (commercial)

Personal goodwill usually cannot be transferred

What is commercial goodwill attributed to?
- Technology
- Patents
- Customers
- People
- Potential
- Distribution rights
- Certain contracts
Goodwill Calculation

Going concern value $ 1,450,000
Less Tangible Asset Backing (380,000)
Intangible asset value (goodwill) $ 1,070,000

Goodwill Multiple Analysis (Goodwill/Metric)

Maintainable Unlevered Discretionary Cash Flow 3.8 x
EBITDA 3.1 x
TAB 2.8 x

Goodwill 74% $ 1,070,000
Tangible Asset Backing 26% 380,000
Going concern value 100% $ 1,450,000
Questions