Maximizing the Value of Your Business

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RKFISCHER AND ASSOCIATES

Business Valuation

- What does it really mean?
  - It establishes a standard measure of value used to determine the business worth.
  - Difference views between:
    - Business Value – Value that delivers earnings that provide a reasonable ROI
    - Owner's Value – Blood, sweat, tears, my baby!

- Components of Business Value
  - Net Book Value – What you own minus what you owe
    - If new owner needs to invest – this takes away value
  - Net Present Value of future cash flows
    - No one has crystal ball, so past results may be indicative of the future
    - Look for 3-5 years of past financial statements
  - Synergy
    - Find someone to buy your business that has outstanding vision to increase value

Business Valuation

- What does it really mean?
  - Keep a clean balance sheet and keep your assets up to date
  - Ensure income statement shows growth in revenues and earnings
  - Don't keep all your eggs in one basket
  - Treat your suppliers and customers very well
- Why would a business owner really care?
  - If you want increased value for your business, it does not happen over night
  - If you want a bidding war – results have to be stellar
  - New owners do not like surprises – sometime purchase price is tied to future events
  - Succession planning objectives:
    - Best deal is to find a leader in your market with cash to burn
    - Ok deal is to find an investor / buyer
    - Worst deal is to sell to family member
  - Objectives will drive your behaviour and determine what you need to accomplish

Asset Value versus Business Value

- Balance Sheet
  - Current Assets (resources I can use for the next year; cash & accounts receivable)
  - Fixed Assets (what I own for the foreseeable future; plant, property & equipment)
  - Current Liabilities (what I owe this year / usually next 90 days)
  - Long Term Liabilities (what I owe for the foreseeable future; mortgage)
  - Equity (what is left over after I pay all debts. Increases as I make more money)

- Income Statement
  - Revenues
  - Cost of Goods Sold (usually the variable costs)
  - Gross Margin (what I make on each unit/$ sold)
  - Expenses (mostly fixed or project costs)
  - Income (what is left over; called retained earnings)

At the end of the year

Asset Value versus Business Value

- **Balance Sheet**
  - Current Assets (what I have for the next year)
  - Fixed Assets (what I own for the foreseeable future)
  - Current Liabilities (what I owe this year / usually next 90 days)
  - Long Term Liabilities (what I owe for the foreseeable future)
  - Equity (what is left over)

BUYING ASSETS

- **Income Statement**
  - Revenues
  - Cost of Goods Sold (usually the variable costs)
  - Gross Margin (what I make on each $ sold)
  - Expenses (mostly fixed or project costs)
  - Income (what is left over)

- **Need to pay off debts**
- **Employees?**
- **Future value of income stream?**
- **May still be liable – pending or unknown law suits?**

Asset Value versus Business Value

- **Balance Sheet**
  - Current Assets (what I have for the next year)
  - Fixed Assets (what I own for the foreseeable future)
  - Current Liabilities (what I owe this year / usually next $
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BUYING ALL THE SHARES OF A BUSINESS

- No need to pay off debts
- Employees go with the deal
- Future value of income stream
- Purchaser liable for pending or unknown law suits?

- **Income Statement**
  - Revenues
  - Cost of Goods Sold (usually the variable costs)
  - Gross Margin (what I make on each $ sold)
  - Expenses (mostly fixed or project costs)
  - Income (what is left over)

At the end of the year

BUYING ALL THE ASSETS OF A BUSINESS

- Seller responsible to pay off debts
- Employees not necessarily go with the deal
- Purchaser not liable for pending or unknown law suits?

Methods to Establish a Business Value

- **Fair Market Value** – business worth to an average investor based upon today only

- **Investment Value** – value to a buyer with a specific purpose in mind such as an expected ROI

- **Intrinsic Value** – value based upon potential benefits to a potential owner

FMV < Investment Value < Intrinsic Value

FMV < Investment Value < Intrinsic Value

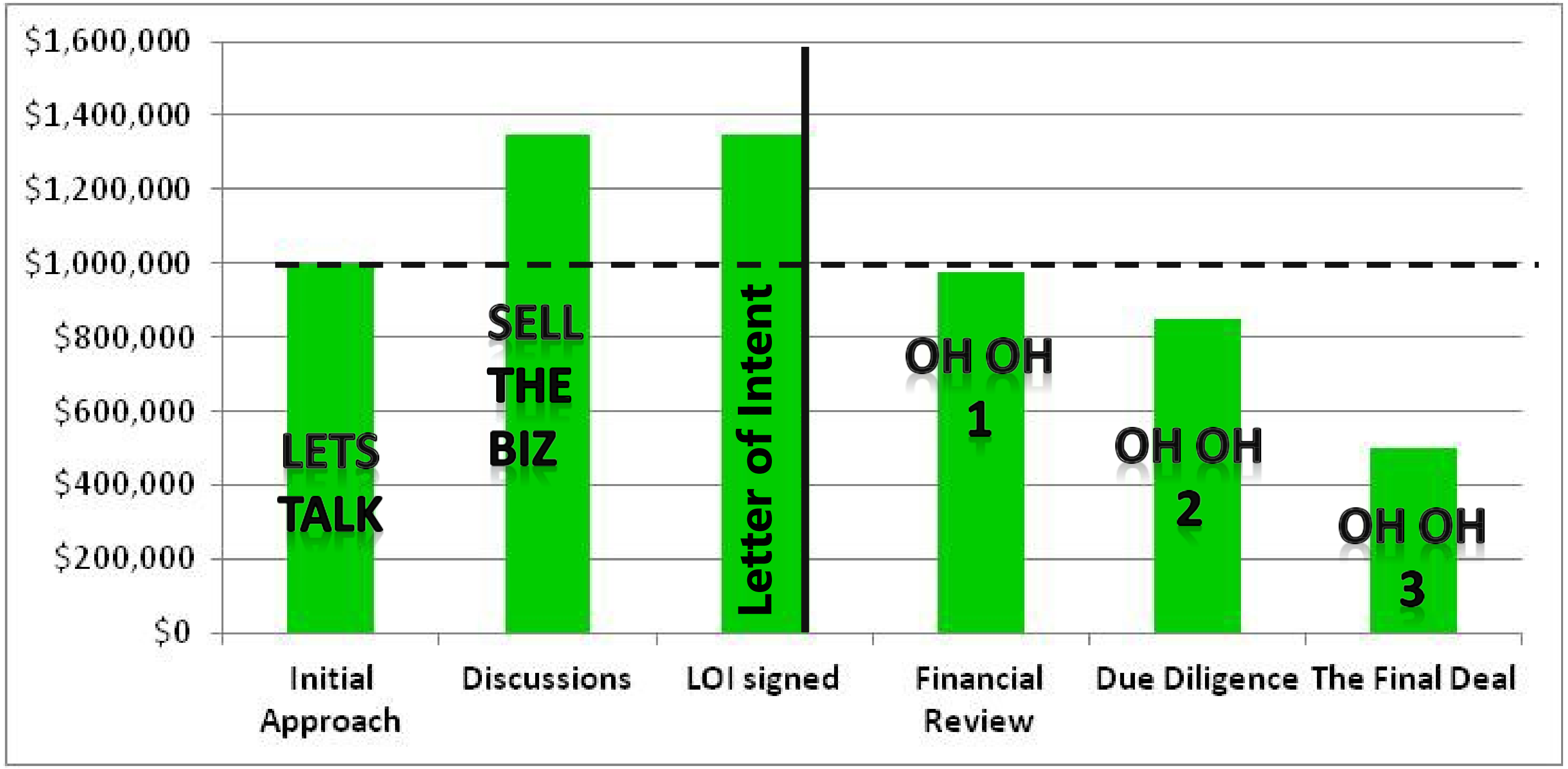
Methods to Establish a Business Value Calculations

- **Fair Market Value (aka Net Book Value)**
  - All Assets (FMV) – Liabilities
- **Investment Value**
  - NPV of future Cash Flows + PV of business ‘x’ years from now (Compare with Bonds, Mortgages etc.)
- **Intrinsic Value**
  - NPV of future Cash Flows + PV of business x years from now + growth acquirer will get because of synergies

Synergies – What you Want Buyers to See

- Represents “Goodwill”
- This how we can get $Billion valuations for a garage
- Goodwill = Price Paid – Market Value
- Only happens when:
  - Value attached to Purchasers plan for Companies combined
    - **IS GREATER THAN**
  - Value attached to company being acquired
- Examples:
  - Patents that purchaser can use elsewhere
  - Customer lists that represent additional sales
  - Technology, Products and/or Skills that selling company possesses
  - Combined; costs reductions can be achieved

Process of Setting the Final Sales Price



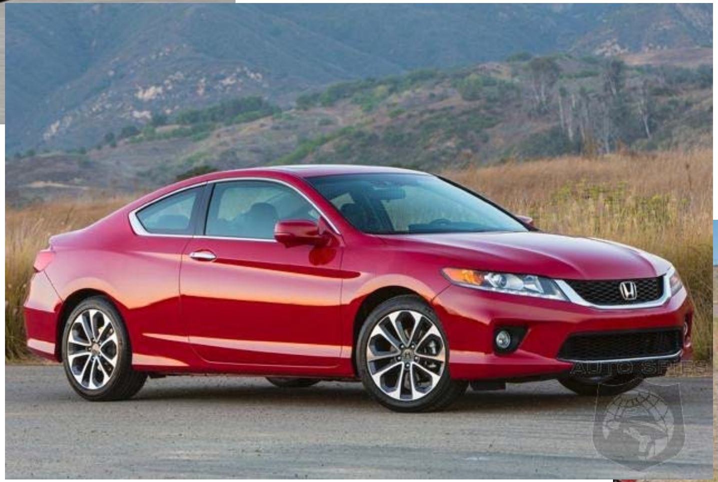
Letters of Intent usually do not allow the seller to consider additional suitors until a decision is made to not go forward

The Infamous OH-OH's

- Past sustained earnings not as strong as promoted (or are inconsistent)
- Investment in assets required
- CRA is owed money
- Negative Working Capital – choosing who to pay & when
- Long collection periods
- Aging and/or unskilled work force (for the task at hand)
- Financial leverage is too high (Debt to Equity >3)
- Impending law suits
- Undocumented liabilities (contracts for services)
- Large or many customer contracts near end of life
- Product, Service and/or Quality problems

Owner versus Buyer Views

Owner Thinks



Reality

Buyer Believes

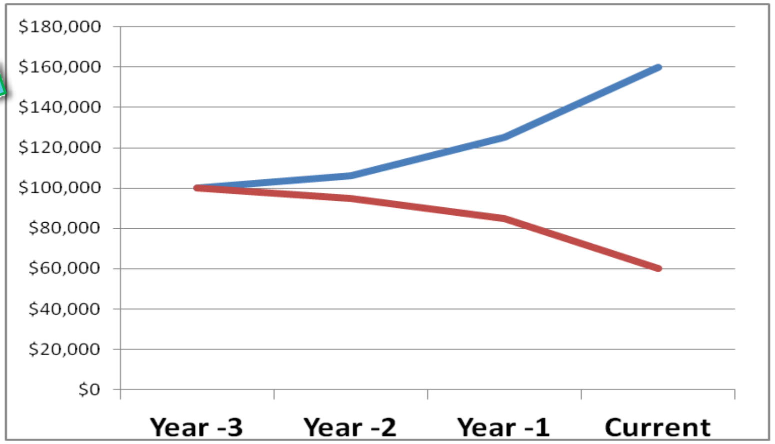
Underlying Principles

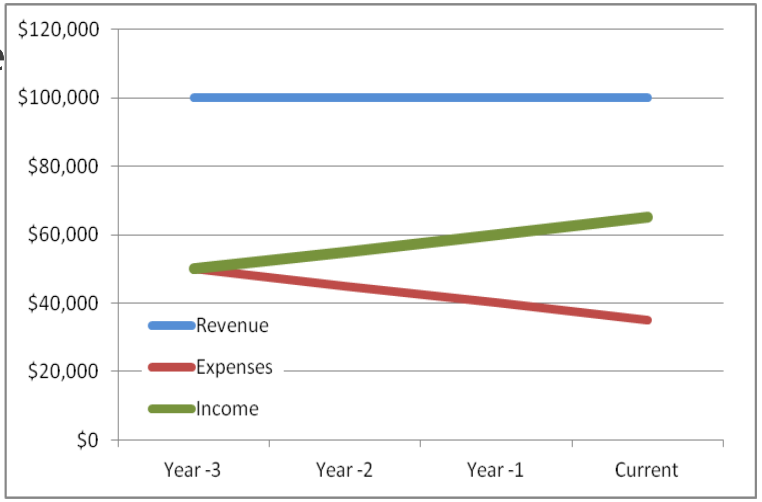
- BATNA – Best Alternative To A Negotiated Agreement
  - Buyers know when to walk away
  - Owners know (think they know) when to walk away
    - Based on emotion
    - Based on business principles
- Always being compared to the next best thing
- Quality of Earnings
- Quality of Customers (and Market)
- Quality of Assets (including skills)
- Quality of Management
- Need to track your business going forward so you don't end up with the usual "OH-OH problems" down the road.
- Does not happen over night – need minimum 2 years to plan (if the current year is good)

Quality of Earnings

Which one would you want to buy?

- Rising earning could indicate lack of investment
- Expenses: devil is in the details
  - Owners taking out too much
  - Spending controls weak
  - Special deals with relatives
  - Funding a life style
  - Related parties on payroll / contract without a role in the
- Need to run the business by the numbers
- Growth vs Declining earnings (NPV 5yr @ 5%)
  - 5% growth can add ~10% value
  - 5% decline can remove ~9% value
  - 10% growth can add ~21% value
  - 10% decline can remove ~17% value





Quality of Customers

- One time sales versus monthly recurring
- Contracts versus purchase orders
- Aging versus emerging
- Engaged versus disengaged
- Paying versus chasing (A/R aging)
- Happy versus stuck
- Many versus a few
- Growing versus shrinking
- High margin versus no margin
- What is the average life time value of a customer?

Quality of Assets

Things that reduce the price of an assets is the investment required to bring the asset in to a productive reliable state

Ex: See a 3 year old car for sale – owner is asking $25,000

- You determine after some due diligence (Mechanic) that:
  - New tires and brakes are required
  - Oil has not been changed in last 3 years
  - Kilometers driven is 120,000
  - Engine making noises
  - Cost to make road-worthy ~ $10,000
- What would you pay?
  - If you could buy it from dealer for $35,000 certified & with warranty
  - If similarly aged, road worthy cars are going for $30,000

Lesson: If the purchaser needs to upgrade equipment or skills, then this reduces value

Quality of Assets

Assets have future value:

- **Is a contract worth more if remaining term is:**
  - 1 year or 5 years?

Is a patent worth more if:

  - Got it approved 2 years ago or Expires next year?

- **What the banks look for (Asset mix important):**
  - Fixed assets can be offered as collateral – up to 80% funding
  - Accounts Receivable <90days – maybe 50% - more likely 30%
  - Goodwill – 0%
  - Negative Equity? 0%
  - Debt to Equity <2.0 (after loan is considered)
  - Why important? Acquirer may need access to additional funds

Quality of Management

- Has the business been neglected?
  - Stagnant or shrinking customer base
  - Assets not being kept up to date
  - No R&D or marketing spend
  - Paying yourself versus the CRA
  - Paying yourself versus investing in the business
  - No Product / Service road map
  - High staff turnover
  - Skills not being updated
  - Low productivity (very common)
- Is the team capable of sustaining the business without the owner?

How To Increase Business Value

- Make sure your business has robust documented processes, procedures
- Ensure revenues and earnings are on the rise – past 3 years
- Remove 'lifestyle' expenses from Income Statement
  - For every $100 reduced, could return $433 in value (5 yr NPV effect
  - Clean up "special deals"
- Clean up the Balance Sheet
  - No shareholder loans
  - Assets up to date and productive with a good remaining life to them
  - Positive Working Capital
- Keep up to date with the CRA
- Make sure your staff is well trained and motivated and you retain them
- Follow good business practices – make sure you get an ROI in spending

Core Questions for 5 Year Plan

- Define a 5 Year Plan
  - Who are your customers?
  - What market segments do you sell into/ including geographies?
  - How do you plan to reach them?
  - What is your average revenue per customer?
  - What is your revenue by product /service type?
  - Are you a product leader, cost leader, or customer intimacy leader?

Core Questions for 5 Year Plan

- **Look at Past 3 Years** - think forward about how you are going to improve your financial results
  - Is this going to obtained through marketing and market awareness ?
  - Is this going to be obtained through addition of new products or services ?
  - Is this going to be obtained by adding additional new channels to market?
  - Is this going to be obtained through acquisition or merger?
  - Is this going to be obtained through reducing expenses?
  - Is this going to be obtained through retaining customers?

Contact Us

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