Understanding and Increasing the Value of Your Business

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Some Principles of Good Business

- Vision
- Perspective
- Effective Leadership
- Innovation
Entrepreneurship

"Why join the navy if you can be a pirate?"

- Steve Jobs
Risk

“Failure is not an option—it comes bundled with the software.”

- Unknown
"The successful man is the one who finds out what is the matter with his business before his competitors do."

-Roy L. Smith
Why Should You Care?

- Wealth and retirement planning
- Succession planning
- Estate Planning
- Share sales
- Financial Reporting
- Litigation
- Other transactions
Basic Definition of a Business

a. A commercial or industrial enterprise and the people who constitute it
b. An organization operated with the objective of making a profit from the sale of goods or services
c. An enterprise, commercial entity or firm, in either the private or public sector, concerned with providing products or services to satisfy customer requirements
“A group of individuals with a plan (strategy) incorporating systems and procedures to efficiently utilize the tangible and intangible assets they have available to meet the needs and wants of their identified customer base.”

American Society of Appraisers
Components of a Business

* Strategy
* Systems
* People
* Tangible and Intangible Assets
Highly successful businesses have the ability to get the most out of the manageable parts – the business strategy, systems and people.
Five Solid Business Practices for Enhancing Business Value

* The importance of solid financial statements
* Keeping **business business** and **personal personal**
* Understanding benchmark ratios and margins in your industry
* Using leverage optimally and responsibly
* Moving personal goodwill to your team and your company
Maintain Solid Financial Statements

- Start with solid accounting
- Generally Accepted Accounting Principles (GAAP), IFRS, etc.
- Generally means accrual accounting
- Have your books reviewed by CPA or CA so that there is someone that can be called for questions by interested buyers
- Remember the 3 statements that need to be correct:
  - Balance Sheet, Income Statement and Cash Flow Statement
Revenues are accrued when owed; i.e. invoices are generated when work is completed

Expenses are accrued when owed; i.e. bills are entered before necessarily being paid

Credit card transactions when they are posted; not paid

Net income not distributed is converted to retained earnings on the balance sheet
• Money owed to you creates an asset called Accts. Receivable
• Money you owe creates a liability called Accts. Payable
• Unpaid payroll booked as a liability
• Unpaid shareholder distributions booked as a liability
• Shareholder capital can be equity or liability (will it be paid back?)
Create asset accounts for each asset held
Depreciate according to normal schedules (expense)
Real Estate should be at market value
Notes payable booked as a liability (not expense)
Inventory should be FIFO not LIFO
Separating Personal from Business

- Running personal assets and expenses through your company’s books distorts the value of the company
- Lifestyle Businesses are typically run down until profit is nil, then shareholder has to kick in to keep running
- Difficult to analyze company ratios
- No tax advantage in Cayman
- Remove non-operating assets/liabilities
  - Real estate and vehicles can be leased from owner
## Structure of a Business

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities &amp; Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>Current Liabilities</td>
</tr>
<tr>
<td>Cash</td>
<td>Accounts Payable</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>Accrued Expenses</td>
</tr>
<tr>
<td>Inventory</td>
<td>Income Taxes Payable</td>
</tr>
<tr>
<td>Other Assets</td>
<td>Other Current Liabilities</td>
</tr>
<tr>
<td>Net Working Capital</td>
<td>Interest Bearing Debt</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>(includes current portion</td>
</tr>
<tr>
<td>Equipment</td>
<td>and short term notes payable)</td>
</tr>
<tr>
<td>Buildings</td>
<td>Stockholders’ Equity</td>
</tr>
<tr>
<td>Land</td>
<td>Preferred Stock</td>
</tr>
<tr>
<td>Other Assets</td>
<td>Common Stock</td>
</tr>
<tr>
<td>Investments</td>
<td></td>
</tr>
<tr>
<td>Life Insurance</td>
<td></td>
</tr>
<tr>
<td>Intangible Assets</td>
<td></td>
</tr>
<tr>
<td>Identifiable</td>
<td></td>
</tr>
<tr>
<td>Non-identifiable</td>
<td></td>
</tr>
</tbody>
</table>
Net Working Capital

- Current Assets Less Current Liabilities

- Cash and short-term assets expected to be converted to cash within a year less short-term liabilities. Businesses use net working capital to measure cash flow and the ability to service debts. A positive net working capital indicates that the firm has money in order to maintain or expand its operations. Net working capital tends not to add much to the business' assets, but helps keep it running on a day-to-day basis.
Invested Capital

- A combination of all equity and long term debt.
- All of the capital invested by both the equity shareholders and the financiers that create the value of the Enterprise.
- Invested Capital always equals the total value of the assets. (Net Working Capital Plus Non-Current Assets)
- Also referred to as Enterprise Value
- This is not the value of your equity.
Intangible Assets

* **Identifiable Intangible Assets** can include
  - Copyrights, Patents and trademarks
  - Brand, Customer Base, Franchise Agreements
  - Designs, technology, software
  - Contracts, leases, rights, agreements
  - Assembled plant
  - Assembled workforce
  - Etc.
**Unidentifiable Intangible Assets**

- Everything else
- Usually caught up in “Goodwill”
- There are types of goodwill that can be identified, such as “personal goodwill” (not necessarily a good thing)
A going concern is an enterprise that is assumed to (or should) continue operations into the foreseeable future.

If the value of the enterprise is equal to, or less than the value of the net assets, the assumption is “liquidation”.

The determination of which is true, is done by valuing the business based on its income.
How Businesses Are Valued

* Asset Approach (or Cost Approach)
* Market Approach
* Income Approach
* Adjusted Net Assets Method

FMV of the total assets less FMV of total liabilities

Usually does not capture goodwill

Considered to be a “floor value”, and most applicable when a business should be liquidated
Market Approach

Guideline Public Companies Method
Compares P/E ratios of publicly traded companies in the same industry

Guideline Transaction Method
Compares multiples paid for similar privately held companies (Price/Sales, or Price/Discretionary Earnings)
Income Approach

Capitalization of Earnings Method
Cash Flow divided by Cap Rate

Discounted Cash Flow Method
Discounted Present Value of projected future cash flows
Market and Income Approaches
Both Dependent on Income

If the value of the income stream, when capitalized, is more than the value of the assets (less liabilities), the enterprise should continue as a going concern.

If the value of the income stream when capitalized is less than the adjusted net assets, then the company may as well be liquidated.
Business Ratios

- Liquidity / Solvency Ratios
- Efficiency Ratios
- Operating Ratios
- Leverage Ratios
Liquidity Ratios

**Current Ratio** \(\text{(Current Assets / Current Liabilities)}\)

The higher the ratio, the greater the cushion between the firms obligations, and their ability to pay them.
Receivables Turnover \((\text{Sales} / \text{Receivables})\)

- This ratio measures the number of times trade receivables turn over during the year.
- The higher the turnover of receivables, the shorter the time between sale and cash collection.
- Divide 365 by ratio to get average days receivable.
Receivables Turnover \( (\text{Sales} / \text{Receivables}) \)

For example, a company with sales of $720,000 and receivables of $120,000 would have a sales/receivables ratio of 6.0. This means receivables turn over six times a year. If a company’s receivables appear to be turning more slowly than the rest of the industry, further research is needed and the quality of the receivables should be examined closely.
Inventory Turnover (Cost of Sales / Inventory)

Measures the number of times inventory is turned over during the year.

**High**—can indicate greater liquidity or superior merchandising. Conversely, it can indicate a shortage of needed inventory for sales. **Low**—can indicate poor liquidity, possible overstocking, or obsolescence.

On the positive side, it could indicate a planned inventory buildup in the case of material shortages.
Working Capital Turnover \((\text{Sales} / \text{Working Capital})\)

Working capital is a measure of the margin of protection for current creditors. Relating sales to the underlying working capital, measures how efficiently working capital is being used.
Efficiency Ratios

Working Capital Turnover \((\text{Sales} / \text{Working Capital})\)

**Low** ratio (close to zero)—A low ratio may indicate an inefficient use of working capital.

**High** ratio (high positive or high negative)—A very high ratio often signifies overtrading, which is a vulnerable position for creditors.
Operating Ratios

* **Gross Margin** (Gross Profit / Sales)
* **Operating Margin** (EBITDA / Sales)
* **Return on Assets** (Net Income / Total Assets)
* **Return on Equity** (Net Income / Equity)
Leverage Ratios

* Long Term Debt / Equity
* Total Debt / Invested Capital
* Total Debt / Total Assets
* Interest Coverage (EBIT / Interest Exp.)
Using Leverage Optimally and Responsibly

* Leverage means getting a greater return than the cost of capital
* Most small businesses do not exceed 35% - 50% LTD/Invested Capital
* Use leverage to increase working capital for expansion or purchasing new materials
Rules of Thumb: New borrowings should result in Current Ratio of no more than industry norm (around 1.5-2.0 for many industries)

The increase in sales due to new borrowings should double the amount of new borrowings
### Using Leverage Optimally and Responsibly

**SAMPLE OF INCREASING LEVERAGE TO INCREASE VALUE**

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td></td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>70%</td>
<td>$700,000</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>25%</td>
<td>$250,000</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td></td>
<td>$50,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>1.5%</td>
<td>$15,000</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>3.5%</td>
<td>$35,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>100%</td>
<td>$350,000</td>
</tr>
<tr>
<td>Long Term Debt</td>
<td>35%</td>
<td>$122,500</td>
</tr>
<tr>
<td>Equity</td>
<td>65%</td>
<td>$227,500</td>
</tr>
<tr>
<td>Invested Capital</td>
<td>100%</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

- **Return on assets**: 10%
- **Return on Debt**: 29%
- **Return on Equity**: 15.4%
### Using Leverage Optimally and Responsibly

<table>
<thead>
<tr>
<th><strong>New Debt</strong></th>
<th><strong>$100,000</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td><strong>$1,200,000</strong> (adds double new debt)</td>
</tr>
<tr>
<td><strong>Cost of Sales</strong></td>
<td>70%</td>
</tr>
<tr>
<td><strong>Operating Expenses</strong></td>
<td>21%</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td>2.3%</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Long Term Debt</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Invested Capital</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Return on Assets</strong></td>
<td>18%</td>
</tr>
<tr>
<td><strong>Return on Debt</strong></td>
<td>37%</td>
</tr>
<tr>
<td><strong>Return on Equity</strong></td>
<td>36.4%</td>
</tr>
</tbody>
</table>
Getting Rid of Personal Goodwill

* Businesses are discounted for “Key Man”, or personal goodwill
* Delegate customer relationships to managers
* Create a Succession Plan
Succession Planning

- Sometimes the only exit plan is your employees.
- Shares can be sold through incentive compensation earmarked toward paying debt for shares, etc.
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