Understanding and Enhancing 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
Success

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

-Roy L. Smith
Innovation

“I will either find a way or I will create one, but I will not make an excuse”.

Unknown
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
Real World View

“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
Real World View

Highly successful businesses have the ability to get the most out of the manageable parts – the business strategy, systems and people.
Enterprise Value

1. The Value of The Assets

1. The value driven by the earnings that is caused by the use of the assets. The cash flow from earnings supports the value of the assets.
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>Fixed Assets</td>
<td>Interest Bearing Debt</td>
</tr>
<tr>
<td>Equipment</td>
<td>(includes current portion</td>
</tr>
<tr>
<td>Buildings</td>
<td>and short term notes payable)</td>
</tr>
<tr>
<td>Land</td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>Stockholders’ Equity</td>
</tr>
<tr>
<td>Investments</td>
<td>Preferred Stock</td>
</tr>
<tr>
<td>Life Insurance</td>
<td>Common Stock</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

Invested Capital
Invested Capital / Enterprise Value

- 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.
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.
**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.
Intangible Assets

Unidentifiable Intangible Assets

- Everything else
- Usually caught up in “Goodwill”
- Goodwill is the value from the profit not otherwise attributed to identified assets
- There are types of goodwill that can be identified, such as “personal goodwill”

(not necessarily a good thing)
Are you a Going Concern?

- 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

- Liquidation Premise
- Going Concern Premise
How Businesses Are Valued

- **Liquidation Premise** usually means the business value is the sum of the values of the assets less debt.

- **Going Concern Premise** means the business is valued based on its projected earnings (cash flow)
Standards of Value

- **Fair Market Value**: Used for transactions, taxation, etc.
- **Fair Value**: Used for Financial Reporting Purposes
- **Fair Value**: Used for litigation purposes
Standards of Value

- **Fair Market Value** Assumes hypothetical transaction between unidentified parties within the market

- FMV of a partial interest is often discounted for
  1. Lack of Control
  2. Lack of Marketability
Standards of Value

- **Fair Value** (both for litigation and for financial reporting) usually **NOT** discounted

- For litigation, depends on jurisdiction and case precedents.

- For litigation, can assume identified parties (shareholder dissent, etc.)
Levels of Value

LEVELS OF VALUE CHART

- Control Value
  - Control Premium
  - DLOC
- "As if Freely-Traded" Marketable Minority Interest
  - DLOC
- Non-Marketable Minority Interest Value
- Synergistic Value
Levels of Value

CONTROLLING INTEREST

100% Equity Ownership Position
Control Interest with Liquidating Control
51% Operating Control
Two equity holders, each with 50% interest
Minority with largest block of equity interest
Minority with "swing vote" attributes
Minority with "cumulative voting" rights
Pure minority interest - no control features

MINORITY INTEREST
Methods of Business Valuation

- Asset Approach (or Cost Approach)
- Market Approach
- Income Approach
Asset Approach Methods

- 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 (Cap Rate is the inverse of a multiple of cash flow)

Discounted Cash Flow Method
Discounted Present Value of projected future cash flows, discounted at discount (yield) rate
Equity Discount Rates

Prices of company stocks measured over long periods of time, less the risk free rate, equals the *equity risk premium*
Equity Discount Rates

*Equity Risk Premium* is the measurement of the systematic (overall market) risk inherent in purchasing equities or stocks in companies, over and above the risk free rate (i.e. treasury securities)
Equity Discount Rates

Size premiums are derived from measuring equity yields for different size companies
Equity Discount Rates

Industry risk premiums based on measurement of yield rates for companies in different industries less the (market) equity risk premium
Equity Discount Rates

Risk Free Rate
+ Equity Risk Premium
+ Industry Risk Premium
+ Size Premium
+ Company specific risk premium

= Equity Discount Rate
Discounted Cash Flow

Sum of the present value of cash flows and present value of terminal value, discounted at the equity discount rate.
Market and Income Approaches
Both Dependent on Income

- If the value of the income stream, when capitalized, is more than the value of the identified 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.
Avoid the Pitfalls of Using Rules of Thumb

**Rules of Thumb** are usually Price/Earnings multiples that people use to buy and sell their businesses.

The problems are:

- Every business is different and carries different risk
- The parties may be working from financial statements that are not normalized.
Normalization Adjustments

- Adjustments made to both Balance Sheet and Income Statements for valuation purposes
- Adjustments to account for non-regular transactions
- Non-operating / personal assets and liabilities
- Personal expenses
- Capitalize fixed assets and inventory rather than expense
- Mark assets & liabilities to market value
- GAAP or IFRS compliance for Accrual Accounting
Valuations Are Based on Cash Flow

Although we need accrual accounting, valuation is based on cash flow

Cash Flow to Equity: Net income (accrual), add back non-cash charges, less capital expenditures, less increases to working capital, +/- changes in debt principal
Valuations Are Based on Cash Flow

Cash Flow to Invested Capital: Net income (accrual), add back non-cash charges, less capital expenditures, less increases to working capital, plus interest expenses
Maximise Cash Flow

- A business can have significant net income and have no cash flow.
- Best to minimize these deductions to cash flow:
Maximise Cash Flow

- Reduce receivables by being diligent at collections
- Don’t overspend on inventory
- Try not to let capital expenditures far exceed depreciation of assets
Business Ratios

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

Current Ratio (Current Assets / Current Liabilities)

The higher the ratio, the greater the cushion between the firms obligations, and their ability to pay them
Liquidity Ratios

Receivables Turnover (Sales / 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.
Liquidity Ratios

Receivables Turnover (Sales / 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.
Liquidity Ratios

**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.
Efficiency Ratios

**Working Capital Turnover** *(Sales / 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.)
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
Maintain Solid Financial Statements

Accrual Accounting

- 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.
Maintain Solid Financial Statements

Accrual Accounting

- 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?)
Maintain Solid Financial Statements
Accrual Accounting

- 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
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
Using Leverage Optimally and Responsibly

- Rules of Thumb: Short term debt (credit cards) 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 long term debt 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>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</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>EBITDA</td>
<td></td>
<td>$50,000</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>1.5%</td>
<td>$15,000</td>
</tr>
<tr>
<td>Net Income</td>
<td></td>
<td>$35,000</td>
</tr>
<tr>
<td>Total Assets</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>
<tr>
<td>Return on assets</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Return on Debt</td>
<td>29%</td>
<td></td>
</tr>
<tr>
<td>Return on Equity</td>
<td>15.4%</td>
<td></td>
</tr>
</tbody>
</table>
Using Leverage Optimally and Responsibly

<table>
<thead>
<tr>
<th>New Debt</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,200,000 (adds double new debt)</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>70%</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>21%</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$110,000 9.2%</td>
</tr>
<tr>
<td>Interest</td>
<td>2.3% 12%</td>
</tr>
<tr>
<td>Net Income</td>
<td>$82,755 6.9%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Assets</th>
<th>$450,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long Term Debt</td>
<td>$222,500 49%</td>
</tr>
<tr>
<td>Equity</td>
<td>$227,500</td>
</tr>
<tr>
<td>Invested Capital</td>
<td>$450,000</td>
</tr>
</tbody>
</table>

| Return on Assets | 18% Better |
| Return on Debt   | 37% Better |
| Return on Equity | 36.4% Better |
Getting Rid of Personal Goodwill

- Business value often 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.
How are businesses bought and sold?

- **Asset sales**: typically controlling interest, less risk, you have to incorporate and obtain business licenses, etc. Used more for debt free companies, small businesses.

- **Share sales**: could be controlling or non-controlling interests, you inherit the risk of contingent liabilities, etc., but you don’t have to go through as much bureaucracy. More often used when there is inherent debt.
Common Succession Plans

Term Sale

- Buyer places downpayment for between 10%-25% of business, agrees to purchase rest over 2-5 years
- Buyer receives 10% - 25% of shares, while seller retains the others
- Each year buyer uses his share of distributions to pay for additional shares
- Seller stays on salary as a consultant and to assist transition of clients/customers
Common Succession Plans

Seller Financing

- Seller finances all or portion of sale with charge over shares,
- Distributions are used to pay down note
- Interest applies
- Seller sometimes stays on as consultant
Common Succession Plans

Buy-Sell Agreements

- Partners have written agreement between themselves to buy and sell shares and how they are valued
Q&A

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