

The background of the cover features a dark blue gradient. A silver-colored pen is positioned diagonally across the upper half. Several large, stylized dollar signs are scattered throughout: one at the top center, one on the left side, and a large one at the bottom right.

Valuation ^{for} M & A

*Building Value in
Private Companies*

SECOND EDITION

Chris M. Mellen
Frank C. Evans

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Preface

“Value” is an expression of the worth of something, measured using two metrics: return and rate of return. To create and build value, businesses must pursue strategies that raise the return, reduce the risk, or combine the two. Conceptually, this seems obvious, but application is more difficult.

The mystery surrounding a company’s value often causes executives to make bad investment and operational decisions. But these poor choices can be avoided. Accurate valuations are possible, and M&A deals can succeed for both buyers and sellers. The keys to success are in the pages that follow.

Through providing valuation advisory services to thousands of companies and corporate executives, we have developed the tools to accurately measure and successfully build value in companies. By employing these techniques, owners and managers can determine their company’s value, what drives it, and how to enhance that value both in M&A and through daily operations.

In M&A transactions, sellers, buyers, and even their advisors struggle over the value of a business. Often they are frustrated by what they see as the other side’s unrealistic expectations. These uncertainties abound:

- Do profits, often computed as EBIT or EBITDA, represent the company’s true return to shareholders?
- Is the forecasted performance realistic?
- What is an appropriate rate of return or multiple, considering the investment’s risk?
- Should the transaction be structured as an asset or stock deal?
- Has the seller properly prepared and packaged the company to get the best price?
- What personal issues are of critical importance to the seller?
- Has the buyer found the best target and accurately quantified potential synergies?
- Does the deal make sense at the quoted price?

Greater fundamental mystery exists in private companies—those not traded on a public stock market, including thinly traded public companies or divisions of large corporations. Most owners and managers operate these companies year after year without ever knowing the answers to these basic questions:

- What is the company worth?
- How much more would a strategic buyer pay to acquire it?
- What factors most affect the company's stock value?
- What is the owners' real return on investment and rate of return?
- Does that return justify the risk?
- Are owners better off selling, and if so, how and when?

Selling is just one of many options available to a business owner to exit the business. This second edition takes a step back to introduce the growing field of exit planning, explain the unique challenges of private company owner exit decisions and the exit planning process, and discuss some exit alternatives in cases where selling may not currently be the right option for the business owner.

- What financial, nonfinancial, professional, and personal issues must an owner consider in evaluating whether to exit, and, if so, how?
- What exit options other than a sale are available to the business owner?
- What makes planning a private company investment different?
- Why should exit planning for a private company begin now?

There have been considerable changes in the economy since the first edition was written. The economy has increasingly become more knowledge based, where intangible assets are a progressively more significant portion of a company's value, and more global. Financial reporting standards pertaining to M&A transactions are responding—and this second edition has responded.

- What are the unique characteristics of foreign companies to consider in cross-border M&A?
- What are some of the key intangible assets owned by companies, and how are they valued?
- What are the important financial reporting considerations that must be addressed when completing a transaction?
- What are the unique challenges of measuring and managing value in high-tech start-ups to maximize shareholder value?

This book provides the tools to answer these and related questions. It is written for business owners, investors, and managers of companies who lack the guidance of a stock price set by a free and active market. Our solutions to valuation and return on investment questions create accountability and discipline in the M&A process. Our techniques incorporate value enhancement into a private company's annual strategic planning to provide direction to shareholders in their investment decisions. In short, our book is a road map to building value in both operating a company and selling or buying one.

Many investors have heard about building value in a public company where the stock price provides the market's reaction to the company's performance. It is much more difficult to develop a successful strategy and measure performance and ROI accurately when no stock price exists. Difficult, but not impossible.

We invite our readers to employ these techniques to achieve accurate M&A valuations and to build value in daily operations. Trade the mystery for this road map to wealth.

Chris M. Mellen
Frank C. Evans
May 2010

Dedication and Acknowledgments

This book is dedicated to our dear friend and mentor, David Bishop, coauthor of the first edition. Through his formation of the American Business Appraisers national network, David brought us together and provided countless hours of education and guidance to elevate us in the business valuation profession. For that we are deeply grateful.

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Frank Evans

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Winning through Merger and Acquisition

Buyers and sellers can create substantial value through merger and acquisition (M&A). Both can win from a transaction. That is the beauty of deal making. And that is much of the allure that has driven the tremendous volume of M&A activity worldwide over the last two decades.¹ Despite this volume, most businesses are not salable. M&A advisors disqualify roughly 65% to 75% of prospective sellers and, according to a U.S. Chamber of Commerce Study, only 20% of the businesses that are for sale will successfully transfer hands to another owner. This implies that only 5% to 7% of companies actually get sold.

This book focuses on business value—what creates it, how to measure it, how to build it, how to preserve it, and how to maximize it through a transaction. It is this focus that will improve the chances of selling a business. These concepts are equally important to buyers and sellers because both can and should benefit from a deal. But different results frequently occur. Sellers may sell under adverse conditions or accept too low a price due to lack of preparation or knowledge. And every buyer runs the risk of purchasing the wrong business or paying too much. As seen during the Great Recession that began in December 2007, transactions during adverse economic times create their own sets of challenges. That is why understanding value—and what drives it—is critical in mergers and acquisitions.

Wise shareholders and managers do not, however, confine their focus on value to only M&A. Value creation drives their strategic planning and, in the process, creates focus and direction for their company. Their M&A strategy supports and complements their broader goal of building shareholder value, and they buy and sell only when the deal creates value for them.

¹Chapter 5 presents a very necessary second view of the potential results of M&A.

This brings us back to the purpose of this book. It explains how to create, measure, build, preserve, and maximize value in mergers and acquisitions in the context of the broader business goal of building value. Senior managers in most public companies focus on value every day because it is reflected in the movement of their stock price—the daily scorecard of their performance relative to other investment choices. Private companies, however, lack this market feedback and direction. Their shareholders and executives seldom understand what their company is worth or clearly see what drives its value. For this reason, many private companies—and business segments of public companies as well—lack direction and underperform.

Managing the value of a private company, or a division of a public corporation, is particularly difficult because that value is harder to compute and justify. Yet most business activity—and value creation or destruction—occurs at this operational level.

Being able to accurately measure and manage the value of smaller businesses or business segments is critical in the value creation process. And this skill will pay off in M&A as well because most transactions involve smaller entities. Although we read and hear about the big deals that involve large corporations with known stock prices, the median M&A transaction size in the United States between 2004 and 2008 was approximately \$29 million. Smaller deals involving closely held companies or segments of public companies are the scene for most M&A activity.

Therefore, every value-minded shareholder and executive must strive to maximize value at this smaller-entity level where daily stock prices do not exist. The concepts and techniques that follow explain how to measure and manage value on a daily basis and particularly in M&A. The discussion begins with an understanding of what value is.

Critical Values Shareholders Overlook

When buyers see a potential target, their analysis frequently begins by identifying and quantifying the synergies they could achieve through the acquisition. They prepare a model that forecasts the target's potential revenues if they owned it, the adjusted expense levels under their management, and the resulting income or cash flow that they anticipate. They then discount these future returns by their company's cost of capital to determine the target's value to them. Armed with this estimate of value, they begin negotiations aimed at a deal that is intended to create value.

If the target is not a public company with a known stock price, frequently no one even asks what the target is worth to its present owners.

However, the value the business creates for the present owners is all that they really have to sell. Most, and sometimes all, of the potential synergies in the deal are created by the buyer, rather than the seller, so the buyer should not have to pay the seller for the value the buyer creates. But in the scenario just described, the buyer is likely to do so because his or her company does not know what the target is worth as a stand-alone business. Consequently, the buyer also does not know what the synergies created by his or her company through the acquisition are worth, or what the company's initial offer should be.

Sellers are frequently as uninformed or misinformed as buyers. Many times the owners of the target do not know if they should sell, how to find potential buyers, which buyers can afford to pay the most to acquire them, what they could do to maximize their sale value, or how to go about the sale process. After all, many sellers are involved in only one such transaction in their career. They seldom know what their company is currently worth as a stand-alone business, what value drivers or risk drivers most influence its value, or how much more, if any, it would be worth to a strategic buyer. Typically none of their team of traditional advisors—their controller, outside accountant, banker, or attorney—is an expert in business valuation. Few of these professionals understand what drives business value or the subtle distinction between the value of a company as a stand-alone business versus what it could be worth in the hands of a strategic buyer.

The seller could seek advice from an intermediary, most commonly an investment banker or business broker. But these advisors typically are paid a commission—if and only if they achieve a sale. Perhaps current owners could achieve a higher return by improving the business to position it to achieve a greater value before selling. This advice is seldom popular with intermediaries because it postpones or eliminates their commission.

With sound advice so hard to find, sellers frequently postpone sale considerations. Delay is often the easier emotional choice for many entrepreneurs who identify personally with their company. But with delay, opportunities are frequently lost. External factors, including economic, industry, and competitive conditions that may dramatically affect value, can change quickly. Consolidation trends, technological innovations, or regulatory and tax reforms also can expand or contract M&A opportunities and value.

Procrastination also can hamper estate planning and tax strategies because delays reduce options. And the bad consequences are particularly acute when value is rapidly increasing.

Thus, buyers and sellers have very strong incentives to understand value, manage what drives it, and track it to their mutual benefit.

Stand-alone Fair Market Value

With a proper focus on maximizing shareholder value, buyers and sellers begin by computing the target company's stand-alone fair market value, the worth of what the sellers currently own. This value reflects the company's size, access to capital, depth and breadth of products and services, quality of management, market share and customer base, levels of liquidity and financial leverage, and overall profitability and cash flow as a stand-alone business.

With these characteristics in mind, "fair market value" is defined by Revenue Ruling 59-60 of the Internal Revenue Service as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

Fair market value includes these assumptions:

- Buyers and sellers are hypothetical, typical of the market, and acting in their own self-interest.
- The hypothetical buyer is prudent but without synergistic benefit.
- The business will continue as a going concern and not be liquidated.
- The hypothetical sale will be for cash.
- The parties are able as well as willing.
- The hypothetical seller is not forced to sell (i.e., accept an offer that represents a "distress sale") and a buyer is not compelled to buy (i.e., necessary to earn a living).
- The reference is to "price" rather than "proceeds."
- The parties operate at arm's length, or independent of each other.
- Both parties have reasonable knowledge of the relevant facts.
- The seller must be willing to accept the price available under prevailing economic, industry, and market conditions as of the effective date.

The buyer under fair market value is considered to be a "financial" and not a "strategic" buyer. The buyer contributes only capital and management of equivalent competence to that of the current management. This excludes the buyer who, because of other business activities, brings some "value-added" benefits to the company that will enhance the company being valued and/or the buyer's other business activities (e.g., being acquired by other companies in the same or a similar industry). Also excluded is the buyer who is already a shareholder, creditor, or related or controlled entity who might be willing to acquire the interest at an artificially high or low price due to considerations not typical of the motivation of the arm's-length financial buyer.

The seller in the fair market value process is also hypothetical and possesses knowledge of the relevant facts, including the influences on value exerted by the market, the company's risk and value drivers, and the degree of control and lack of marketability of that specific interest in the business.

While fair market value is impersonal in nature, "investment value" reflects the value to a particular buyer based on that buyer's circumstances and investment requirements. This value includes the synergies or other advantages the strategic buyer anticipates will be created through the acquisition.

Fair market value should represent the minimum price that a financially motivated seller would accept because the seller, as the owner of the business, currently enjoys the benefits this value provides. The controlling shareholder in a privately held company frequently possesses substantial liquidity because he or she can harvest the cash flow the company generates or sell the company. The lack-of-control or minority shareholder generally possesses far less liquidity. As a result, the value of a lack-of-control interest is usually substantially less than that interest's proportionate ownership in the value of the business on a control basis.

Prospective buyers who have computed stand-alone fair market value should also recognize that this is the base value from which their negotiating position should begin. The maximum value the buyer expects to create from the deal is the excess of investment value over fair market value. So any premium the buyer pays above fair market value reduces the buyer's potential gain because the seller receives this portion of the value created.

As discussed further in Chapter 6, sellers frequently are motivated by nonfinancial considerations, such as their desire to pass ownership of the company on to their children or long-term qualified employees, or, if they work in the company, to retire or do something else. When these nonfinancial considerations exist, it is particularly important for shareholders to understand the financial effect of decisions made for personal reasons. Opportunistic buyers can take advantage of sellers, particularly those who are in adverse personal circumstances. Once again, this fact stresses the need for a continual focus on value and implementation of a strategic planning process that routinely considers sale of the company as a viable option to maximize shareholder value. This process accommodates shareholders' nonfinancial goals and provides the time and structure to achieve them and manage value as well.

Investment Value to Strategic Buyers

The investment value of a target is its value to a specific strategic buyer, recognizing that buyer's attributes and the synergies and other integrative

EXHIBIT 1.1 Fair Market Value versus Investment Value

Investment Value – 2	
Investment Value – 1	
	Acquisition Premium
Fair Market Value	

benefits that can be achieved through the acquisition. Also known as strategic value, the target’s investment value is probably different to each potential buyer because of the different synergies that each can create through the acquisition. For example, one buyer may have a distribution system, product line, or sales territory in which the target would fit better than with any other potential buyer. Generally this is the company to which the target is worth the most. Well-informed buyers and sellers determine these strategic advantages in advance and negotiate with this knowledge.

The difference between fair market value and investment value is portrayed in Exhibit 1.1, which shows an investment value for two potential buyers. The increase in investment value over the company’s fair market value is most commonly referred to as a control premium, but this term is somewhat misleading. Although the typical buyer does acquire control of the target through the acquisition, the premium paid is generally to achieve the synergies that the combination will create. Thus, this premium is more accurately referred to as an acquisition premium because the primary force driving it is synergies, rather than control, which is only the authority necessary to activate the synergy.

The obvious questions this discussion generates are:

- Why should a buyer pay more than fair market value?
- If the buyer must pay an acquisition premium to make the acquisition, how much above fair market value should the buyer pay (i.e., how large should the acquisition premium be, either as a dollar amount or as a percentage of fair market value)?

The mean and median acquisition premiums for purchases of public companies in the United States have been about 40% and 30%, respectively, over the last 10 years. These figures are not presented as a guideline or as a target. Premiums paid are based on competitive factors, consolidation trends, economies of scale, and buyer and seller motivations—facts that again emphasize the need to thoroughly understand value and industry trends before negotiations begin. For example, a company with a fair market value of \$10 million has a much stronger bargaining position if its maximum investment value is \$20 million than if it is only \$12 million.