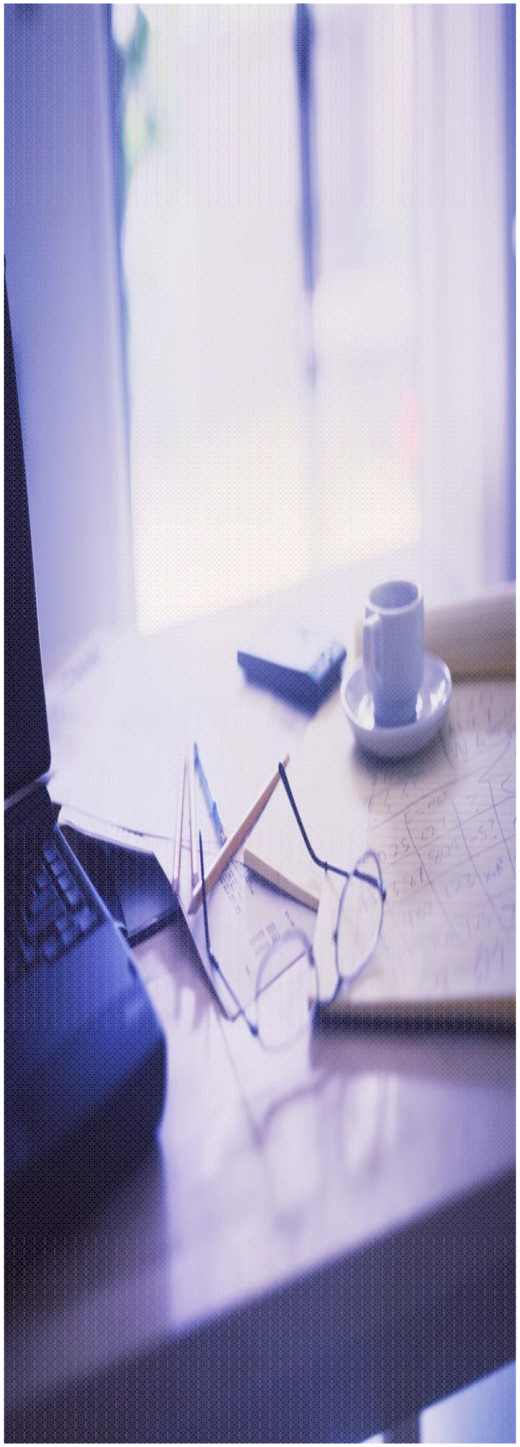

Understanding Value and How to Maximize It

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Tonight's session

- Who are we?
- Valuation methodologies
- Goodwill
- Maximizing value when selling a business
- Preparing to sell
- Questions

Who are we?

<u>Services</u>

- Business valuations
  - Acquisitions/Divestitures
  - Matrimonial matters
  - Shareholder disputes
  - Estate planning
- Ownership transition
- Income loss claims
- Forensic accounting

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Valuation methodologies

- Going concern
  - Asset based
  - Income based (earnings or cash flow)

- Liquidation

Valuation methodologies (cont.)

- Going concern
  - Company is earning a sufficient <u>rate of return</u> on its net assets or equity
    - Assets – Liabilities = Equity
  - For example:
    - Equity invested, at FMV = **$200,000**
    - Appropriate rate of return = **25%** (aka, *capitalization rate*)
    - ∴ Company must generate at least **$50,000** in after-tax cash flow or earnings per year (on average) to be a going concern.
  - Where a company generates more than a sufficient rate of return, <u>goodwill</u> likely exists.

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Valuation methodologies (cont.)

- Liquidation
  - Company is earning an insufficient rate of return.
  - ∴ A prudent owner would liquidate and invest remaining cash in other ventures.
  - Value = Net proceeds on sale of assets

    - Corporate income taxes

    - Liabilities

    - Liquidation costs (severance, legal fees, etc.)

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Going concern – Asset based

- When should the GC asset based approach be used?
  - Value of the company is derived from its underlying assets (e.g., holding company).
  - Company generates most of its revenues from competitive bids (tenders).
    - Everyone is “putting food on the table”, but nobody is “getting rich”.
  - Goodwill exists, but it is personal (not commercial).

Going concern – Asset based (cont.)

	As at December 31, Year 5			
	Net Book Value	Adjustments	Fair Market Value Operating	Fair Market Value Redundant
Assets				
Current assets				
Cash	$ 10,000		$ 10,000	
Marketable securities	50,000	15,000		$ 65,000
Inventory	325,000		325,000	
Prepaid expenses	13,000		13,000	
	398,000		348,000	65,000
Equipment, net				
Computer software	20,000		20,000	
Equipment	150,000	12,000	162,000	
Furniture and fixtures	60,000		60,000	
Leasehold improvements	80,000	20,000	100,000	
	310,000		342,000	-
	708,000		**690,000**	**65,000**
Liabilities				
Current liabilities				
Accounts payable	$ (90,000)		$ (90,000)	
Income taxes payable	(18,000)		(18,000)	
	(108,000)		(108,000)	-
Bank loan	(190,000)		(190,000)	
	(298,000)		**(298,000)**	**-**
Net assets *(before tax considerations)*	**$ 410,000**		**$ 392,000**	**$ 65,000**
Tax disadvantage to a purchaser of shares			(10,000)	(5,000)
Net assets *(after tax considerations)*			**$ 382,000**	**$ 60,000**
Fair market value of shares *(assuming no goodwill)*			**$442,000**	

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Going concern – Income based

- When should the GC income based approach be used?
  - Company generates more than a "normal" rate of return on its net assets (equity).
  - Revenues are generated primarily from repeat customers and/or unsolicited business.
  - Goodwill can be transferred to a purchaser.
    - The name and reputation of the company have eclipsed those of its owner(s).

Income based approach – Maintainable earnings

	For the year ended December 31,				
	Year 1	Year 2	Year 3	Year 4	Year 5
Revenues	**$ 750,000**	**$ 800,000**	**$ 1,000,000**	**$ 1,200,000**	**$ 1,500,000**
Net income before income taxes	**$ 37,500**	**$ 50,000**	**$ 70,000**	**$ 96,000**	**$ 115,000**
Adjustments:					
Interest income		(2,500)	(2,750)	(3,000)	(3,250)
Personal expenses	5,000	5,000	10,000	10,000	15,000
Shareholder-employee wages	80,000	80,000	150,000	175,000	200,000
Partially adjusted earnings	**$ 122,500**	**$ 132,500**	**$ 227,250**	**$ 278,000**	**$ 326,750**
Weighting - Low	*-*	*-*	*-*	*1*	*1*
Weighting - High	*-*	*-*	*-*	*-*	*1*
Weighted average - Low (rounded)	**$ 300,000**				
Weighted average - High (rounded)	**$ 330,000**				

	"Low"	"High"
Maintainable partially adjusted earnings	**$ 300,000**	**$ 330,000**
Less: Shareholder-employee wages - economic	(125,000)	(125,000)
Maintainable earnings before income taxes	**175,000**	**205,000**
Less: Income taxes at 13.5%	(23,625)	(27,675)
Maintainable earnings after income taxes	**$ 151,375**	**$ 177,325**
Rounded	**$ 150,000**	**$ 180,000**

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Income based approach – FMV of Operations

	Low	High
Maintainable earnings after income taxes	**$ 150,000**	**$ 180,000**
Multiplier *(inverse of capitalization rate)*	**4.0**	**4.0**
Fair market value of operations	**$ 600,000**	**$ 720,000**

Indicated goodwill and other intangible assets:

	Low	High
Fair market value of operations *(as per above)*	$ 600,000	$ 720,000
Less: Fair market value of net operating assets	(382,000)	(382,000)
	$ 218,000	**$ 338,000**
Years of earnings in goodwill and other intangible assets	*1.5*	*1.9*

Income based approach - FMV of shares

	Low	High
Fair market value of operations	$ 600,000	$ 720,000
Fair market value of redundant assets	60,000	60,000
Fair market value of shares	$ 660,000	$ 780,000

Midpoint	$ 720,000

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Goodwill

- In order to have value, goodwill must be transferable ("commercial" goodwill).

- "Personal" goodwill has no commercial value and is not part of FMV.
  - Celebrities
  - Some medical, legal and other professional practices
  - Revenues are dependent on the unique skills and reputation of the <u>owner</u>

Goodwill (cont.)

- "Individual" goodwill is where there is a key person whose skills, contacts and reputation are critical to the business.
  - Unlike personal goodwill, individual goodwill <u>can</u> be transferred to a purchaser.
  - Assumption is that the key individual can be replaced <u>eventually</u>, without a sustained decline in profitability.

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Maximizing value when selling

- The linkage between “Value Math” and “Value Levers”
- The realities of M&A transactions
- Overview of the divestiture “process”
- Questions needed to be asked when preparing to sell <u>and why</u>

The Linkage between “Value Math” and “Value Levers”

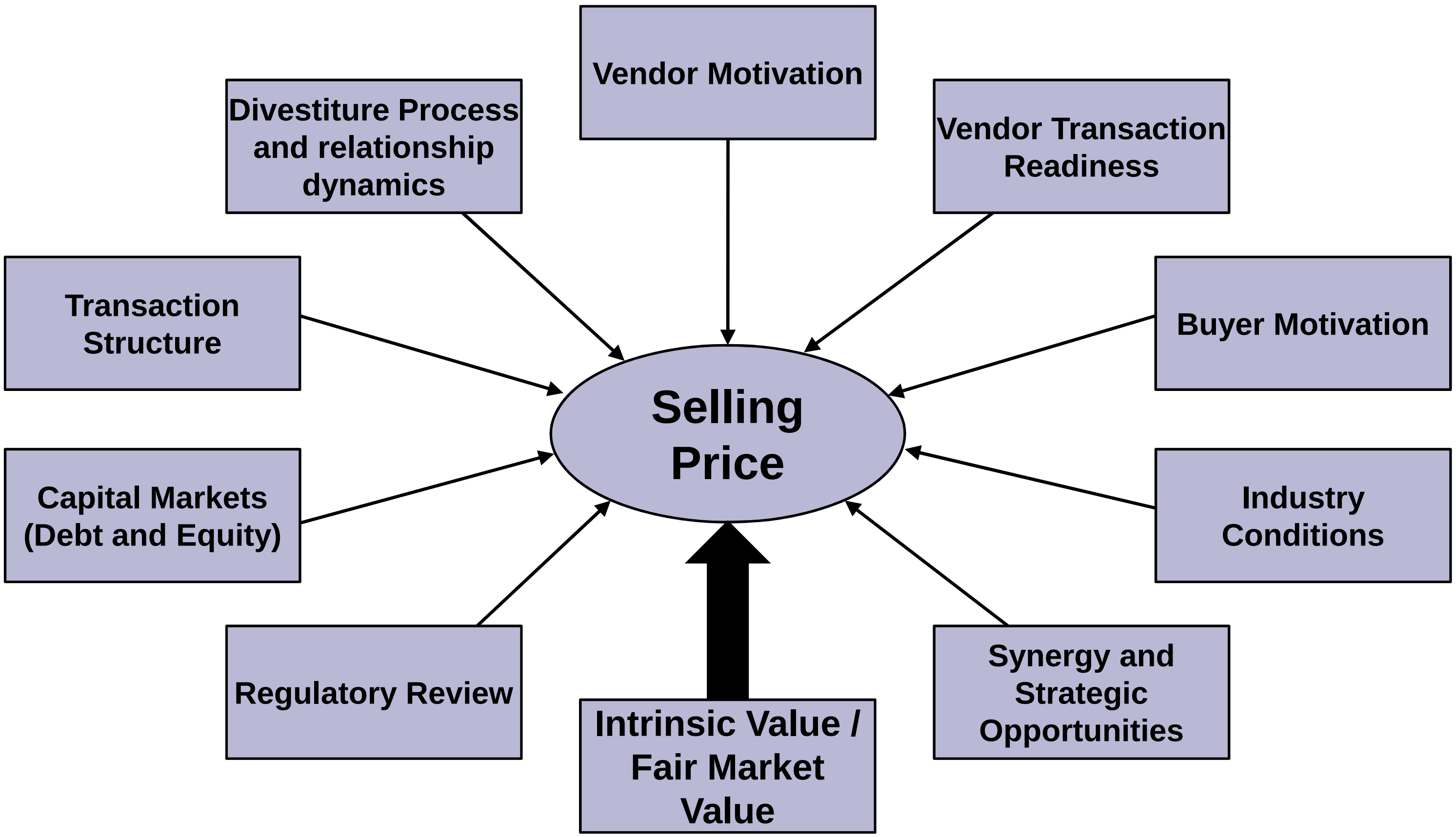
The Basic Equations

1. A + B = C
   Tangible assets
   + Intangible assets
   = Value of a business
2. E x M = C
   Indicator of future earnings
   x Applicable multiple
   = Value of a business

Core Value Levers

- Quantity of assets or earnings - More is always better in terms of price !
- Quality of the assets
- Transferability of assets
- Sustainability of earnings
- Ability to reduce or control risks
- Adding certainty for the buyer

M&A Transaction Realities



So . . . price may not equal fair market value
But also . . . price is what you pay and value is what you get!

The Divestiture "Process" Overview

- Distinct phases from the vendor's perspective
  (not always in a straight line and frequently need to circle back)

  1. Self-assessment – *understand your business and objectives*
  2. Pre-offering preparation steps – *becoming "transaction ready" by getting your house in order*
  3. Generate awareness – *actively marketing the opportunity to the targeted prospects*
  4. "Open House" – *due diligence*
  5. Narrow the bidder market – *exclusivity*
  6. Negotiations
  7. Closing the transaction
  8. Post-sale exit – *needs to be planned, too (personal and corporate)*

- Timing
  - Varies widely but generally 6 to 12 months
  - Management needs to be prepared for the commitment

This evening . . . Getting ready to sell a business

Getting ready for sale – ***Initial*** Questions!

- Questions to drive the "self-assessment" phase
- Responses drive the "pre-offering preparation" steps
- The "value lever considerations" will drive the price up or down

Going to market before a business is ready will push the price down

Getting ready for sale – ***Initial*** Questions!

Selected Issues	Value Lever Considerations
1. Why does the owner want to sell?	• retirement? • duress? • not keeping pace with industry trends?
2. What is the owner's timing?	• motivated to "do a deal"? • phased exit? really needed?
3. What is being sold?	• 100% or minority interest? • assets vs. shares? (NB – tax implications for buyer and seller) • real estate included? Re-org needed?
4. Can management explain the business?	• documented business plan? • what is the upside? • appropriate financial reporting / information systems? • unusual event or trends that affect historical results or projected cash flows

Getting ready for sale – ***Initial*** Questions (Cont'd.) !

Selected Issues	Value Lever Considerations
5. Critical assets – products / brands	• key processes documented? • IP protection possible? In place? • competition? • supplier dependency?
6. Critical assets – customers	• reliance on any major customers? • customer claims / warranty problems?
7. Critical assets – people	• impact of losing key personnel? • personnel under contract? • non-competition agreements?
8. Critical assets – premises / equipment	• long-term control (whether owned or leased)? • Production capacity? Future CAPX?
9. Regulatory compliance and supporting documentation	• environmental • sales and income taxes • labour code • pending litigation

Getting ready for sale – ***Initial*** Questions (Cont'd.) !

Selected Issues	Value Lever Considerations
10. Likely buyers - Who?	• competitors? • financial investors? • next generation of family? • management?
11. Likely buyers – Why motivated? and to what extent?	• synergies? • new entrant from related industry? • defensive play? • "transaction ready" themselves?
12. Prospective buyer's ability to fund the purchase price	• nature of the assets • capital markets • buyer's own resources • vendor take-back financing
13. Vendor's experience and advisory resources	• need for a multi-disciplinary team • adequate time and financial commitment

And the list goes on . . .

More Questions – Please!

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