

VALUATION OF YOUR BUSINESS

Introduction

- I. Why is Valuation a Critical Tool?
- II. Valuation Issues – General
- III. Valuation of Technology Firms for Estate and Gift Tax Planning and Compliance
- IV. Valuation of Technology Firms for Acquisition/Merger Purposes

Introduction (cont.)

- V. Valuation of Technology Firms for Strategic Planning Purposes
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I. Why is Valuation a Critical Tool?

- Historically, Many Privately-Owned Businesses Have Been Family-Owned and Family-Run Businesses
- Historically, Many Were Owned by the Second or Third Generation of the Founding Family
- Ownership of an Equity Interest in Such a Business Has Been Viewed as an Income-Producing Opportunity, Not an Asset With Substantial Value

I. Why is Valuation a Critical Tool (cont.)

□ Three Critical Reasons for Valuation

- Estate and Gift Tax Planning and Compliance**
- Mergers and Acquisitions**
- Strategic Planning**

II. Valuation Issues - General

Three Basic Approaches to Valuation

- The Income Approach (the Discounted Cash Flow Approach)
- The Market Approach (the Public Market Comparable Approach and the Comparable Acquisition Approach)
- The Cost Approach

II. Valuation Issues - General (cont.)

- The Discounted Cash Flow Approach
 - Project the Net Revenues to Be Generated by the Company
 - Project the Expenses Associated With That Net Revenue Stream, Analyzing the Variable/Fixed Nature of Various Expenses, Excluding Interest Expense
 - Subtract the Expenses and Income Taxes From the Net Revenues to Obtain Net Income

II. Valuation Issues - General (cont.)

- The Discounted Cash Flow Approach (cont.)
 - Convert the Net Income to Cash Flow by Adding Back Depreciation, Subtracting Capital Expenditures, and Subtracting Increases in Working Capital, but Not Subtracting Principal Payments
 - Discount the Forecasted Debt-Free Cash Flows Back to Present Value, Thereby Accounting for Both the Time Value of Money and Forecasted Risks, Yielding Total Consideration

II. Valuation Issues - General (cont.)

- The Discounted Cash Flow Approach (cont.)
 - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value

II. Valuation Issues - General (cont.)

- The Public Market Comparable Approach
 - Identify Publicly Traded Comparable Companies
 - Analyze the Financial and Operating Performance of the Public Companies
 - Analyze How Investors Are Pricing the Public Companies, and Why

II. Valuation Issues - General (cont.)

- The Public Market Comparable Approach (cont.)
 - Make Inferences About How Investors Would Price, or Value, the Subject Company Through the Utilization of Various Ratios Such as:
 - Market Value of Total Capital/Net Revenue
 - Market Value of Total Capital/Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA)
 - Market Value of Total Capital/EBIT
 - Market Value of Equity/Book Value of Equity

II. Valuation Issues - General (cont.)

- The Public Market Comparable Approach (cont.)
 - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value

II. Valuation Issues - General (cont.)

- The Comparable Acquisition Approach
 - Identify Acquisitions of Comparable Companies
 - Analyze the Financial and Operating Performance of the Acquired Companies
 - Analyze How Buyers Are Pricing the Acquisitions, and Why

II. Valuation Issues - General (cont.)

- The Comparable Acquisition Approach (cont.)
 - Make Inferences About How Buyers Would Price, or Value, the Subject Company Through the Utilization of Various Ratios Such as:
 - Market Value of Total Capital/Net Revenue
 - Market Value of Total Capital/Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA)
 - Market Value of Total Capital/EBIT
 - Market Value of Equity/Book Value of Equity

II. Valuation Issues - General (cont.)

- The Comparable Acquisition Approach (cont.)
 - Subtract the Face Value of Interest-Bearing Debt From the Total Consideration, Yielding Equity Value
 - The Comparable Acquisition Approach is Typically Only Utilized to Value 100 Percent Interests

II. Valuation Issues - General (cont.)

□ The Cost Approach

- Adjust Assets and Liabilities, Both On- and Off-Balance Sheet, to Market Value
- Difficult to Identify and Value Intangible Assets, Such as Customer List and Goodwill; Therefore, the Cost Approach Tends to Undervalue a Company

II. Valuation Issues - General (cont.)

- The Cost Approach (cont.)
 - The Theory is That a Company Utilizes its Entire Bundle of Assets, Including Tangible Assets, Working Capital, and Intangible Assets, to Generate the Primary Driver of Value: Cash Flow
 - Therefore, the Cost Approach is Typically Only Utilized to Value Holding Companies (i.e. Non-Operating Companies) or Companies Which Should Be Liquidated

II. Valuation Issues - General (cont.)

- Other Valuation Considerations
 - Value Indications Must Be Adjusted for Factors Related to:
 - The Size of the Interest Being Valued (Minority v. Majority Interest)
 - On a Per Share Basis, an Investor Would Be Willing to Pay More for a Share of a Controlling Interest Than for a Share of a Minority Interest Holding

II. Valuation Issues - General (cont.)

- Other Valuation Considerations (cont.)
 - Value Indications Must Be Adjusted for Factors Related to: (cont.)
 - The Lack of Marketability of a Closely Held (Private) Company
 - The Capital Structure
 - Assets Included or Excluded

III. Valuation of Technology Firms for Estate & Gift Tax Planning & Compliance

- The Basis of All Estate Planning
 - On a Per Share Basis, an Investor Would Be Willing to Pay More for a Share of a Controlling Interest Than for a Share of a Minority Interest Holding
 - The Owner of a Minority Interest Has Limited Power and Control in Company Operations
 - The Owner of a Minority Interest Typically Has No Power to Influence Corporate Policy, Including the Existence and Timing of Cash Distributions

III. Valuation of Technology Firms for Estate & Gift Tax Planning & Compliance

- The Basis of All Estate Planning (cont.)
 - Concept is Made Tangible When One Observes the Premiums Paid Over the Minority Interest Price in the Acquisition of a Controlling Interest in a Publicly Traded Company
 - Concept is Accepted by Both the IRS and the Tax Courts
 - ~~□~~ Magnitude of the Discount is Subject to Question
 - ~~□~~ Therefore, the Goal is to Have All IRS Transfer Taxes (Gift and Estate) Calculated on Minority Interest Transfers

III. Valuation of Technology Firms for Estate & Gift Tax Planning & Compliance

- A Well-Planned Program of Gifting Minority Interests Over Time Can Ultimately Reduce the Overall Transfer Tax Burden by Taking Advantage of Discounts for Both Minority Interest and Lack of Marketability Considerations on Each Transfer, as Well as the Annual \$10,000 Per Child Tax Exclusion Provided by the IRS

III. Valuation of Technology Firms for Estate & Gift Tax Planning & Compliance

- Such a Series of Transfers Could Ultimately Lead to the Reduction of a 100 Percent Interest to a Minority Interest Itself by the Time of Death, at Which Point Estate Taxes Would Also Be Calculated on a Minority Interest Basis

III. Valuation of Technology Firms for Estate & Gift Tax Planning & Compliance

Family Limited Partnerships, Multiple Classes of Stock, and Other Sophisticated Estate Planning Techniques

- Can Satisfy Family Goals Which May Initially Seem at Odds
 - Income Needs
 - Long Term Capital Preservation Needs
 - Estate Value Reduction Requirements
 - Control of Asset Needs
 - Business and Operational Requirements

III. Valuation of Technology Firms for Estate & Gift Tax Planning & Compliance

- Family Limited Partnerships, Multiple Classes of Stock, and Other Sophisticated Estate Planning Techniques (cont.)
 - Benefits, Especially the Reduction of Gift and Estate Taxes, Can Be Enhanced Through the Use of Valuation Discounts

IV. Valuation of Technology Firms for Acquisition/Merger Purposes

Alternative I - Market/Income Approach

- Create Historical Pro Forma Cash Flow Statement

 - Typical Adjustments

 - Excess Owners' Compensation

 - Real Property Lease

 - Non-Recurring Expenses

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Typical Adjustments (cont.)
 - Other Personal or Discretionary Expenses on the Books of the Company
 - Automobile Leases
 - Compensation and Perks to Family Members
 - Discretionary Types of Insurance Coverage
 - Discretionary T&E and Club Dues
 - Discretionary Retirement Contributions

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

Sample Calculation of Pro Forma Cash Flow (A)

	As is	Adjusted
Net Revenue	15,000,000	15,000,000
Cost of Sales	11,250,000	11,250,000
Gross Profit	<u>3,750,000</u>	<u>3,750,000</u>
Owner's Compensation	700,000	300,000
Building Lease	120,000	80,000
Other Operating Expenses	<u>2,470,000</u>	<u>2,470,000</u>
EBITDA	460,000	900,000

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Most Transactions Have Been Occurring at Multiples Ranging From 4.0 to 6.5 Times Adjusted EBITDA
- Sample Valuation (Using the Cash Flow Calculated on the Prior Page - Example A):

Adjusted EBITDA	900,000
Multiple	<u>5.3</u>
Purchase Price	4,770,000
Less: Outstanding Debt	<u>1,000,000</u>
Pre-tax Proceeds to Shareholders	3,770,000

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market / Income Approach (cont.)

Sample Calculation of Pro Forma Cash Flow (B)

	<u>As is</u>	<u>Adjusted</u>
Net Revenue	50,000,000	50,000,000
Cost of Sales	<u>39,000,000</u>	<u>39,000,000</u>
Gross Profit	11,000,000	11,000,000
Owner's Compensation	1,500,000	500,000
Non-Recurring Expenses	1,000,000	0
Discretionary Retirement Contrib.	350,000	0
Other Operating Expenses	<u>7,150,000</u>	<u>7,150,000</u>
EBITDA	1,000,000	3,350,000

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Sample Valuation (Using the Cash Flow Calculated on the Prior Page - Example B):

Adjusted EBITDA	3,350,000
Multiple	<u>5.5</u>
Purchase Price	18,425,000
Less: Outstanding Debt	<u>4,000,000</u>
Pre-tax Proceeds to Shareholders	14,425,000

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I – Market/Income Approach (cont.)

- Most Transactions Have Been Occurring at Multiples of Adjusted EBITDA Ranging From 4.0 to 6.5, Yielding Total Consideration
 - Factors Impacting the Purchase Price Multiple
 - Size
 - Profitability

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Factors Impacting the Purchase Price Multiple (cont.)
 - Quality of Revenue
 - Is it Sustainable?
 - Is it Overly Dependent Upon One or a Few Customers?
 - Growth Trends
 - Mix of Product Lines

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Factors Impacting the Purchase Price Multiple (cont.)
 - Potential Synergies and Economies of Scale
 - Stability/Reputation
 - Environmental Liabilities
 - C Corporation v. S Corporation v. Partnership

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Factors Impacting the Purchase Price Multiple (cont.)
 - Level of Working Capital or Net Asset Value to Be Delivered at Closing
 - A Business is a Bundle of Assets Which Are Used Together to Generate a Cash Flow Stream; Included in This Bundle Are Tangible Assets, Intangible Assets, and Working Capital

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Factors Impacting the Purchase Price Multiple (cont.)
 - Level of Working Capital or Net Asset Value to Be Delivered at Closing
 - Assets Included or Excluded
 - Quality of Inventory and Accounts Receivable
 - Can the Inventory Be Sold at Retail Values?
 - Are the Accounts Receivable Collectible?

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Factors Impacting the Purchase Price Multiple (cont.)
 - Total Consideration or Equity Value
 - Quality of the Financial and Operating Information, i.e. Can it Be Verified?

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Factors Impacting the Purchase Price Multiple (cont.)

- Opportunities for Buyer

- Revenue Growth From Existing Customers
- New Marketing
- Product Line Expansion
- New Services
- Subsequent “Fold-in” Acquisitions

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative I - Market/Income Approach (cont.)

- Factors Impacting the Purchase Price Multiple (cont.)
 - Seller's Near Term Capital Requirements for Computer Systems, Manufacturing Facilities, Expansion of Facilities for New or Extended Product Lines, Etc.
 - Motivations of the Buyer and the Seller
 - Timing - Seller's Market

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Alternative II - Cost Approach

	<u>Net Book Value</u>	<u>Transacted Value</u>
Cash	200,000	1,000
Accounts Receivable	2,000,000	1,950,000
Inventory	2,500,000	2,400,000
Real Property	250,000	1,000,000
Personal Property	200,000	200,000
Intangible Assets	<u>0</u>	<u>1,000,000</u>
Total Net Book Value	\$ 5,150,000	
Total Consideration		\$ 6,551,000

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Cost Approach

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Market/Income Approach

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Additional Considerations

- Composition of Purchase Price
 - Cash
 - Stock
 - Note
 - Contingent Note
 - Subordinated to Senior Indebtedness
 - Based on Future Financial Performance

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Additional Considerations (cont.)

- Important Ancillary Agreements
 - Employment Agreements
 - Owners
 - Sales Force
 - Non-Compete Agreements with Key Managers
 - Real Property Lease

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Additional Considerations (cont.)

- Tax and Legal Considerations
 - Form of Business Organization
 - C Corporation v. S Corporation v. Partnership
 - Legal Structure of Transaction
 - Assets v. Stock Acquisition
 - Accounts Receivable/Working Capital
 - Tax Considerations

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Transaction Structure	Seller	Buyer
C corporation - Desired form of transaction - Tax implications - Non-compete allocation	stock single level of tax at capital gains rates low	assets write-up assets and increase depreciation low
S corporation/Partnership/LLC - Desired form of transaction - Tax implications - Non-compete allocation	indifferent single level of tax at capital gains rate low	assets write-up assets and increase depreciation low
Generally speaking, buyers and sellers would avoid the following:		
C corporation – (less desirable) - Form of transaction - Tax and other implications - Non-compete allocation	assets double level of tax at ordinary rates high	stock inability to write-up assets; risk of assuming off-balance sheet liabilities low

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Additional Considerations (cont.)

- Evaluating Potential Partners
 - Strong Management Team
 - Experienced Acquisition Team
 - Aligning Incentives
 - Attractive Governance Structure

IV. Valuation of Technology Firms for Acquisition/Merger Purposes (cont.)

Additional Considerations (cont.)

- Evaluating Potential Partners (cont.)
 - Momentum
 - Currency and Capital
 - Communication

V. Valuation of Technology Firms for Strategic Planning Purposes

- The Primary Goal of Value-Based Management (VBM) is to Create a Corporate Culture in Which Decisions and Practices Are Focused on the Creation of Shareholder Value

V. Valuation of Technology Firms for Strategic Planning Purposes (cont.)

- Various “Metrics” Can Be Used to Measure Business Value And/or the Change in Business Value
 - Stock Price
 - Earnings Per Share
 - Return on Invested Capital (ROIC)
 - Economic Value Added (EVA)®
 - Cash Flow Return on Investments (CFROI)

V. Valuation of Technology Firms for Strategic Planning Purposes (cont.)

- In the Absence of Regular Objective Feedback Regarding Value, it Can Be Much Easier for Private Company Managers to Lose Their Focus
- It is Critical to Understand the Primary Drivers of Company Value and to Use This Understanding as the Foundation for Business Decisions Such as:
 - The Sale or Purchase of a Business or a Business Segment
 - Significant Capital Expenditures
 - New Business Initiatives