

Building Value in Private Companies
XPX Boston Breakfast Seminar
Presented by Chris Mellen – Delphi Valuation Advisors, Inc.
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I. Seminar Overview

1. Most owners and managers operate their businesses without ever knowing:
 - a. What their business is worth;
 - b. How much more a strategic buyer would pay to acquire it;
 - c. What factors affect the company's stock value; and
 - d. Whether they would be better off selling or exiting in some other fashion.
2. The objective of this Seminar is to:
 - a. Discuss the metrics needed to maximize our clients' companies' value;
 - b. How we can help them determine their return on investment (ROI) in their company as part of their overall investment strategy; and
 - c. How value depends on many exit options available to business owners.

II. Current Environment

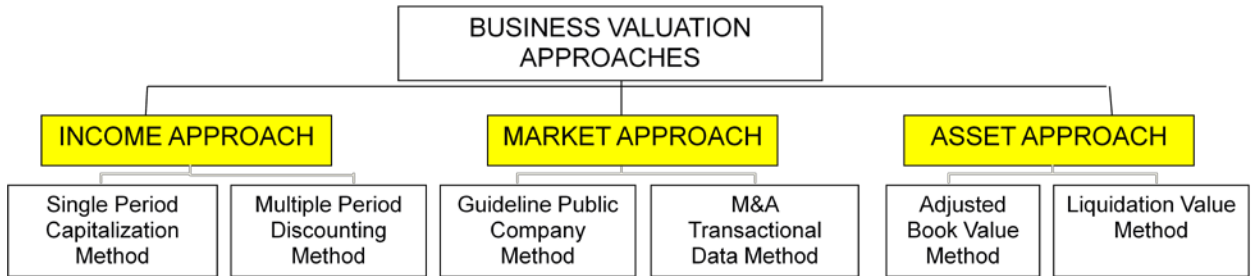
1. Rise in middle market deal volume
 - a. 33 transactions were completed in Q3 2010 (based on data from 151 private equity firms for transactions between \$10 million and \$250 million) – *Source: GF Data*
 - b. This represents the highest number of deals in the previous seven quarters.
 - c. The average EBITDA multiple on these of deals was 6x TTM (trailing 12 months) – up from the low to mid 5's in the previous four quarters.
 - d. Message: M&A is making its way back as a strong option for owner exit.

III. Public v. Private Companies

1. Public companies receive certain advantages from having actively traded stock:
 - a. Daily market price information (daily performance feedback from investors).
 - b. Industry analysts provide routine analysis and reactions.
 - c. Strict accounting and disclosure requirements encourage full disclosure.
 - d. Demanding, well-informed, institutional investors aggressively promote high returns.
 - i. **RESULT:** Generally a very heavy emphasis on maximizing shareholder value.
2. Private companies are without a formal market and lack a continuous measure of performance and stock value. As a result, shareholders often:
 - a. Lose focus on value and stray toward non-financial goals.
 - b. Don't know value and how much different buyers would pay.
 - c. Fail to accurately measure both long and short term management performance.
 - d. Fail to identify contributing factors that increase or decrease stock value.
 - e. Fail to accurately compute their ROI.
 - f. Fail to evaluate sale of stock on a continuous basis.
 - **RESULT:** ROI is inadequately emphasized, so the highest possible returns are not achieved.

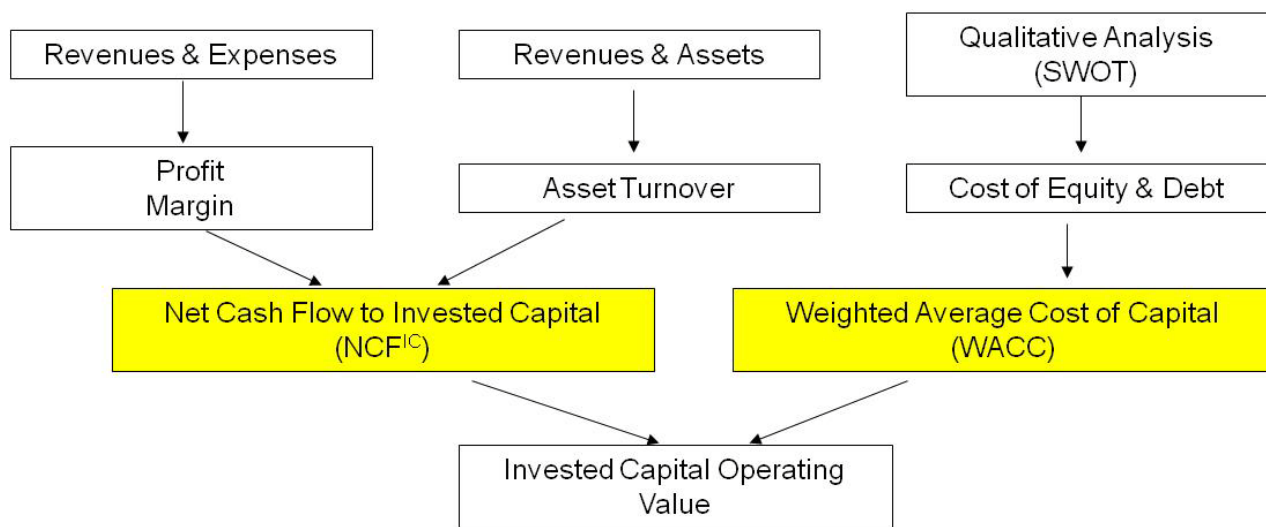
3. Solution:
 - a. Provide the missing information through a valuation-based strategic plan.
 - b. This produces essential stock price information and decision-making criteria.
 - c. It also recalibrates expectations and sets the stage for the exit plan.

IV. Approaches to Value



Income Approach	*Market Approach	Asset Approach
The company derives significant value from its operations.	There is an adequate number of companies that are reasonably similar to the subject company.	The company owns a significant amount of tangible assets.
The company generates a positive income or cash flow.	There are merger and acquisition transactions that involve targets that are reasonably similar.	The company creates little value from its operations.
The company possesses significant intangible value.	There is adequate data available about the companies used for comparative purposes.	The company's balance sheet includes most of its tangible assets.
The company's risk can be accurately quantified through a rate of return.	The companies generate multiples that provide a reasonable indication of market conditions and prices as of the appraisal date.	It is possible to obtain accurate appraisals of the value of the company's assets.
The company's future performance can be accurately estimated through a forecast.	The subject company is large enough to be compared to the companies used in the market approach.	The ownership interest being appraised possesses control or access.
*This discussion of the market approach only refers to applications of the guideline public company and merger and acquisition methods.		

V. Components of Value Creation



VI. Valuation Metrics

1. Private company valuation metrics for value creation and ROI:
 - a. Investment
 - b. Return
 - c. Rate of return
 - d. Value
2. Investment
 - a. Which of the next points constitute the correct measure of your investment in your private company?
 - i. The initial investment you and other shareholders made in the company, plus any subsequent investments.
 - ii. Your investment in the company, plus any profits reinvested (this would be the book value of equity on your balance sheet).
 - iii. The current market value (regardless of what you paid for them) of all the tangible assets that you use in the operations of your business.
 - b. Lesson 1: The key measure for current decisions is the value of your investment today.
 - c. Lesson 2: In an underperforming company that is not realizing its intangible value, your investment consists primarily of the current value of the company's tangible assets and working capital.
 - d. Lesson 3: For companies that generate profits in excess of their cost of capital, the owner's investment in the business is the present value of the company's anticipated future returns. Most value lies in these companies' intangible assets.
3. Return
 - a. The most common measures of return in valuation for M&A are EBIT and EBITDA.
 - b. However, return is the annual cash flow that your company generates from its operations that is available for owners to take out of the company without harming it.
 - c. For more precise valuations, the appropriate return is net cash flow to invested capital, defined as follows:

Net Income (after taxes)
Add: Interest expense, net of income tax
Add: Non-cash charges (i.e., depreciation and amortization)
Less: Capital expenditures
Less: Increased investment in working capital

4. Rate of Return

- a. Required rate of return (i.e., cost of capital or discount rate) is used to quantify the likelihood that the future returns will be achieved (quantifies risk).
- b. Actual rate of return reflects the historical performance, and is used to compute companies' actual ROI.
- c. Your actual return may be above or below what you should be earning based on your investment's risk.
- d. The required rate of return is the benchmark you must achieve to create value.

5. Value

- a. Must recognize the different standards of value that are applicable in M&A:
 - i. Fair Market Value
 - Value to a financial buyer (bringing only cash).
 - Value in the hands of the present owners (representing the owners' current investment in the business). Owners elect to make this investment every day they don't sell it.
 - ii. Investment Value
 - Value to a strategic investor who can create higher returns, lower capital investment, or lower risk.
- b. Must recognize how degrees of control and marketability affect value of individual equity investments.

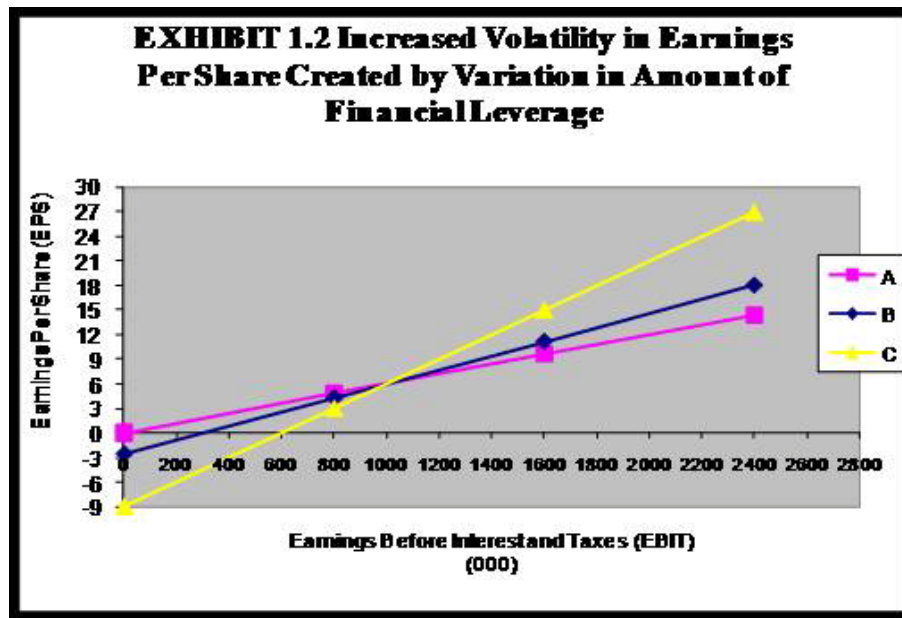
VII. Continuum of Value



VIII. How Debt Financing Affects ROI

1. Debt funds enable business owners to lever, and thereby increase, the return they earn on their equity. However, the leverage effect can also lower the investor's return.
2. Exhibits 1.1 and 1.2 further illustrate this.
3. Private company owners should review their capital structure annually as well as before any major capital expenditure, refinancing, or ownership change is contemplated. With a clear understanding of the risk/reward consequences of creative financing, owners can both increase their ROI and better achieve their other financial goals in the process.

EXHIBIT 1.1 Balance Sheet (\$000s)										
Investors are considering three capital structures – A, B, or C – to provide \$10 million of capital for their company. Assuming an interest cost of 10%, an income tax rate of 40%, and a stock price of \$1,000 per share, note how the earnings per share (EPS) varies with the capital structures at the three different levels of earnings before interest and taxes (EBIT).										
Net Operating Assets			Liabilities and Equity							
			Capital Structure		A		B		C	
			Interest Bearing Debt		0		3,000		6,000	
			Equity		10,000		7,000		4,000	
Total			10,000		10,000		10,000		10,000	
Calculation of Earnings Per Share With Different Capital Structures at Different Levels of Earnings (\$000s) except Earnings Per Share										
Capital Structure	A	B	C	A	B	C	A	B	C	
EBIT	800	800	800	1,600	1,600	1,600	2,400	2,400	2,400	
Interest Expense (10%)	0	300	600	0	300	600	0	300	600	
EBT	800	500	200	1,600	1,300	1,000	2,400	2,100	1,800	
Income Tax (40%)	320	200	80	640	520	400	960	840	720	
Net Income	480	350	120	960	780	600	1,440	1,260	1,080	
Number of Shares	100	70	40	100	70	40	100	70	40	
EPS	4.80	4.29	3.00	9.60	11.14	15.00	14.40	18.00	27.00	



IX. Operating Options to Enhance ROI

1. Option 1: Investment (current value) – Reduce the investment in net operating assets employed without causing returns to decrease or risk to increase.
 - a. *Example:* Turn inventory more frequently to reduce the required investment from a market value of \$3.0 million to \$2.5 million, and pay out the \$500,000 to shareholders.
2. Option 2: Return (net cash flow) – Increase forecasted net cash flow returns without increasing the investment in the company or its risk.

- a. *Example:* Increase net cash flow by \$100,000 through improved advertising, which when capitalized at 10%, yields \$1 million in increased company value.
3. Option 3: Rate of Return (risk) – Decrease the company’s risk without increasing shareholder investment or impairing net cash flow returns.
 - a. *Example:* Reduce customer concentration and cut the company’s WACC capitalization rate from 10% to 9.5%. When the forecasted return of \$1.2 million is capitalized at 9.5%, company value is increased by \$630,000.
4. Conclusion: ROI can be enhanced through a combination of reduced investment, improved returns, or lower risk.

X. Questions & Concerns in Maximizing ROI

1. Do investors in public companies also focus on net cash flow to invested capital in computing ROI?
2. How does a company’s actual performance versus expectations affect value?
3. Does a key change in a company’s competitive position, such as a breakthrough in technology, the emergence of a new strong competitor, or the loss of a key person, affect value?
4. When should shareholders focus on a company’s value to a strategic buyer versus its fair market value?
5. Since a lower cost of capital, which reflects lower risk, generates a higher value, can investors create value by increasing debt to lower their company’s cost of capital?
6. Does growth automatically create value?
7. How much can a company’s risk profile change, and can this change be accurately measured?
8. A private company investment earns an actual rate of return of 10%, although, based on its risk profile, it should be generating a required rate of return of 18%. Why would this company’s owner consider selling?
9. Some successful private company owners avoid borrowing because they “do not want to have to pay interest to the bank.” Is there a danger in this attitude?

XI. Risk and Value Drivers – Considerations Driving Value

(Note: each reflects three examples out of many possibilities within each consideration.)

1. Macro
 - a. Industry environment
 - b. Merger and acquisition activity
 - c. Seasonality and cyclicalities
2. Financial
 - a. Revenue growth
 - b. Profitability
 - c. Financial ratios (LAPS – Liquidity, Activity, Profitability, Solvency)
3. Operations
 - a. Strategic/Business Plan
 - b. Technological position
 - c. Structural capital (IP)
4. Management

- a. Human capital
- b. Depth of management
- c. Corporate culture
5. Sales and Marketing
 - a. Competitive position
 - b. Customer concentration
 - c. Backlog
6. Risk and Value Drivers Resulting in a Higher Multiple:
 - a. Possess strong brand name or customer loyalty.
 - b. Operate in a well-maintained physical plant.
 - c. Generate a high and sustainable net cash flow to shareholders.
 - d. Possess competitive advantages (e.g., technology, location, or an exclusive product line).
 - e. Generally favorable economic and industry conditions.
 - f. Sell a diverse mix of products to customers located in broad geographic markets.
 - g. Operate in large, high-growth industry.
 - h. High barriers in industry impede entry by new competition.
 - i. Possess strong position in niche industry.
 - j. Are either the most efficient low-cost producer, or high-quality producer, or both.
7. Risk and Value Drivers Resulting in a Lower Multiple:
 - a. Sales concentrated with a few key customers.
 - b. Operate in a small industry with a limited customer base.
 - c. Have compiled or reviewed, rather than audited financials.
 - d. Operate with deficient working capital and generally limited financial capability.
 - e. Operate with limited management on whom the company is heavily dependent.
 - f. Sell commodity-type products that possess little differentiation from competitors.
 - g. Substantial excess capacity exists in the industry.
 - h. Continual threat posed by substitute products and technological obsolescence.
 - i. Sell products through brokers, creating limited knowledge of or contact with product end users.
 - j. Possess history of litigation with customers, suppliers, and/or employees.

XII. Sources of Synergy

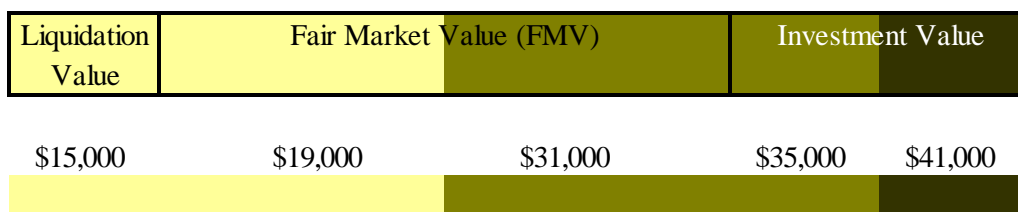
1. Revenue enhancements
2. Cost reductions
3. Process improvements
4. Financial economies
5. Risk reduction

XIII. Exit Planning

1. A sale to a strategic or financial buyer may not be the appropriate exit for the current business owner.
2. There are at least 20 different exit options available to the business owner.
3. The most appropriate option will depend on both the owner's financial and mental readiness, as well as the company's position.

4. Regardless of which exit option is best for the business owner, the owner and his/her management team and advisers must never lose sight of the ongoing importance and need to focus on building value in their companies.
5. Uniqueness of a private company investment
 - a. Standard investment theory urges portfolio diversification, sufficient liquidity, and continual risk vs. return analysis, particularly over time as life circumstances, needs, and goals change.
 - b. A private company investment is typically excluded from a financial advisor's analysis.
 - c. Three characteristics of a private co. investment
 - i. It is typically the owner's largest investment.
 - ii. It is typically the riskiest security in the owner's portfolio.
 - iii. It is his least liquid investment.
6. The vast majority of business owners looking to sell their companies fail to do so within three years of setting out in the process. These owners will be in a much better position to sell at an optimal price in the future if they have an exit plan to initiate alternative plans in the meantime. To begin to understand what an optimal price would be, one must understand the value drivers.

Continuum of Value for Various Exit Options*



Liquidation -> Gift -> ESOP -> MBO -> PEG Recap -> Strategic Buyers

	<u>EBIT</u>	<u>Implied Value</u>
Book Value (1)		\$15,000
FMV of Minority Interest (2)	\$6,900	\$19,000
FMV of Controlling Interest (3)	\$7,650	\$31,000
Investment Value - Horizontal Integration (4)	\$8,650	\$35,000
Investment Value - Vertical Integration (5)	\$10,150	\$41,000

* See notes on next page.

Notes to Continuum of Value Example

- (1) Company's book value at the Valuation Date (Year 5) for liquidation purposes.
We assume no additional adjustments to book value.
- (2) Fair market value of a minority interest for gifting purposes. This assumes that FMV is based on a 4 times EBIT multiple and discounted for lack of marketability by 30%. Because a minority interest is being valued, adjustments for excess compensation are not made.
- (3) Fair market value of a controlling interest, potentially for a PEG recapitalization. This also assumes that FMV is based on a 4 times EBIT multiple. EBIT is adjusted for excess compensation of \$750 and no DLOM is applicable.
- (4) Investment value to a strategic buyer seeking horizontal integration (i.e., expansion into different products that are similar to current lines). Adjusted EBIT of \$7,650 is further adjusted for reduced expenses, resulting in a \$1,000 increase in EBIT. For purposes of this example, a 4 times EBIT multiple is paid, but investment value often reflects a higher multiple (lower discount rate) than FMV.
- (5) Investment value to a strategic buyer seeking vertical integration (i.e., expansion into areas that are at different points of the same production path). Adjusted EBIT is further adjusted for increased revenues as well as reduced expenses, resulting in an additional \$1,500 increase in EBIT.

XIV. Valuation for M&A – Building Value in Private Companies

Discover
the Tools Necessary
to Determine
Your Company's Value.

**Valuation for
M & A**
*Building Value in
Private Companies*
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The book concludes with a chapter containing a comprehensive case study to illustrate concepts and calculations.



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XV. Speaker Bio

Chris M. Mellen is the President of Delphi Valuation Advisors, and the Managing Director of American Business Appraisers. His experience includes completion of over 1,900 business and intangible asset valuations over the past 21 years. Chris holds the Accredited Senior Appraiser (ASA), Master Certified Business Appraiser (MCBA), Accredited in Business Appraisal Review (ABAR), and Certified Merger & Acquisition Advisor (CM&AA) designations. He has served on several valuation committees, published several articles, led numerous seminars, and provided expert testimony in court. Chris is co-author of VALUATION FOR M&A: BUILDING VALUE IN PRIVATE COMPANIES. Prior to founding Delphi in 2000, he held senior level positions in the valuation practices of Tofias and KPMG.

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