



The Business Value Manager

Advice for business owners, investors and service providers on how to build value and wealth through investment in closely held companies.



Did the 2008 Stock Market Crash Cut Your Company's Value?

INTRODUCTION

Probably. While we cannot know with any level of precision without performing a valuation, considering the economy's slow down and the accompanying uncertainty in the credit markets, your private company investment probably lost value. This issue of "The Business Value Manager" offers lessons from this crisis in the financial services industry to help you to build, protect and harvest your private company wealth.

LESSON ONE: VIEW YOUR PRIVATE COMPANY AS AN INVESTMENT

Your company has a value that fluctuates up and down on a daily basis as stock prices in public companies do, but probably even more so. Because your private company is smaller than most public companies, its value is probably more volatile and can sharply increase or decrease.

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Key factors – commonly called risk and value drivers – heavily influence your company's value, so recognizing what these are is essential for successful value management. For most companies, critical value and risk drivers include:

- Quality and depth of management

- Market position and growth potential
- Quality of customers and what ties them most to you
- Differentiation from competitors and your ability to maintain this
- Profit margins and resulting cash flows

Because your company carries substantial risk as an investment, it should provide its shareholders with a commensurate rate of return. And you should be receiving this return annually, first in cash flows you harvest from your company (beyond your market level salary, bonus and fringe benefits, which are returns on your *labor* not on your *investment*). Your private company's value should appreciate as your second form of annual return. Combined, your annual dividends or distributions (some of which you may choose to take in the form of tax deductible *excess* compensation) and your equity appreciation should generate at least a 20% return, given your company's high risk.

LESSON TWO: EVALUATE WHETHER YOUR PRIVATE COMPANY INVESTMENT FITS YOUR CIRCUMSTANCES

If your ownership in your private company is really an investment, as opposed to a

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family legacy asset or your job and lifestyle, then answer this fundamental question: Is it a good investment for you, considering your age, annual spending needs, other sources of income, wealth outside of your company and your overall need for portfolio diversification and liquidity?

For any number of reasons, including ignorance or neglect, many people had much of their wealth invested only in General Motors or Citigroup and have seen most of this value vanish. They paid an enormous tuition to learn the safety provided by portfolio diversification. Similarly, thousands of Enron employees learned about the risks of illiquidity when they saw their company's stock price begin to tank and they were restricted from cashing out of their 401-k's or their stock options.

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So you and every shareholder in your company need to ask:

- How much of my wealth should I concentrate in this one high risk investment?
- How much of my wealth should I concentrate in this one relatively illiquid investment?

Remember, each shareholder's answer to these questions may vary, depending on his or her age, spending needs, other sources of income and other wealth. And as a shareholder's age and other life circumstances change, the appropriateness of this investment for them may change. It is critical to keep these points in mind if one shareholder wants to sell their stock and another does not. Neither is necessarily wrong. They may just have different financial needs and goals.

LESSON THREE: EVALUATE INDUSTRY CONDITIONS

Some companies can trace their bright future to their industry. If you operate in a high growth market or the customers you serve are growing rapidly, you probably have a good chance to enjoy healthy sales and income growth.

Other industries or geographic regions are stagnant or in decline. The negative effects of these conditions are

often exacerbated by excess capacity of suppliers to this industry. This surplus pressures companies to cut prices to grow or even maintain their market share, which reduces or eliminates profits for the whole industry.

So make industry analysis a regular part of your evaluation of your private company investment. Consider its potential for sales and profits growth given the markets in which it operates. If stagnation or decline exits or is likely to occur, getting out of your investment

as soon as possible may be your best way to avoid the poor returns and decline in value that are likely to accompany these circumstances.

LESSON FOUR: EVALUATE COMPANY CAPABILITIES

Having evaluated your company's external environment, now duplicate the process with a focus on your company's internal capabilities. That is, assess your company's ability to compete, now and five and ten years from now. As part of this analysis, answer these questions:

- What is your company's ability, both short and long term, to attract and retain talented and committed employees who will enable your company to at least sustain its current competitive advantage?
- What is your company's ability, both short and long term, to attract and retain customers and generate long term sales growth?
- What is your company's ability to compete in your industry and market compared to your major competitors? Are you stronger or weaker than them, and should this position improve or decline in the long term and why?

LESSON FIVE: EVALUATE TIMING AND WHAT IT WOULD TAKE TO GET OUT SUCCESSFULLY

Should you want or need to sell your private company stock, it takes much more than just calling your broker. Your company may not be ready to sell and it could take one or more years to position it to yield an attractive price and terms. Do you clearly understand what would make your company an attractive target?

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Would most buyers require your key managers, including one or more shareholders, to stay with the company in a sale? The more reliant your business is on these people for leadership, technical knowledge or customer relationships, the more likely it is that they will be required to stay with the company for some period after the sale.

A sale could also be postponed by unfavorable economic or industry conditions that could reduce the price buyers are willing to pay. Owners must also recognize that it typically takes six to twelve months to complete a private company sale. Because most companies would benefit from at least one year of time to prepare to be ready for a sale, owners are well advised to begin their sale planning process five years in advance of a tentative sale date. This lead time will allow them to select ideal economic and industry conditions, prepare the business to be the most attractive possible acquisition target, and meet the retirement or departure needs of key executives who may have to remain with the company for some transition period after the sale.

LESSON SIX: RECOGNIZE THE PERILS ACCOMPANYING LACK OF CONTROL

The benefits of advance planning for a sale that were just described in Lesson Five, are even more critical for any shareholders who own a minority interest in the company. Such investments lack the ability to decide what the company will do, including the decision to sell. And minority interests usually face transfer restrictions that limit how and when they can sell their shares, to whom and even at what price. Accordingly, minority shareholders should annually address and discuss their investment plans and time table with other shareholders to assess their ability to sell out when they want to.

LESSON SEVEN: RECOGNIZE EXTERNAL VULNERABILITIES

The presence of five critical factors, each of which is beyond the shareholder's control, make concentration of your wealth in a private company much more risky in the current economy.

- Most companies now operate in an international economy with more and stronger competitors.
- Governmental regulations, taxes, tariffs and subsidies can materially help or hurt your company's competitive position.
- Technological advances are increasing the pace of change in companies and industries and many smaller companies cannot keep up.
- Larger companies have increasing advantages in channels to market that connect companies to their customers and many smaller companies are hurt by their distribution weaknesses.
- The current crisis in the financial markets has sharply decreased the availability of debt and equity financing and increased the requirements to obtain each source of capital so smaller companies may have difficulties getting the financing they need for growth.

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LESSON EIGHT: RECOGNIZE WHEN YOU NEED PROFESSIONAL HELP

Valuation analysis and transaction planning are usually done for major undertakings. These decisions involve large sums of money and commit shareholders for the long term. Because the stakes are so high, owners and executives should receive an excellent return when they invest in professional advice on these matters.

Well informed decisions require a thorough knowledge of historical and forecasted income and cash flows and confidence in the rates of return used to discount them. Informed investors must also be comfortable with earnings or revenue multiples and how and when to effectively apply them. And you must know when and how to adjust income or apply a discount or premium to a value conclusion. With large sums and long term commitments at stake, recognize the benefits—and savings—that experienced valuation and transaction planning assistance can provide.

CONCLUSION AND RECOMMENDATIONS

It is clearly a new economic environment for private company owners who have probably seen their company's value decline. As a result, it is more important than ever for these investors to recognize the risks they face, clarify their ownership goals and plan annually to achieve them. Call us if you need a process or specific guidance to make sound valuation based decisions.



EVANS AND ASSOCIATES

VALUATION ADVISORY SERVICES

One East State Street Phone: 724-346-0150

P.O. Box 655 Fax: 724-342-4510

Sharon, PA 16146

The best selling book, *VALUATION FOR M&A: Building Value in Private Companies*, was co-authored by E&A principal, Frank C. Evans and David M. Bishop, and published by John C. Wiley & Sons, Inc. To order your copy, go to www.wiley.com/WileyCDA. For a preview, visit our website at www.evansandassociates.net, click the Publications link and Books.



Frank C. Evans, ASA, CBA, CPA/ABV

fevans@evansandassociates.net



Sarah E. DeKreek, ASA

sarah@evansandassociates.net

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