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The Business Value Manager

Is Your Shareholder Agreement a Time Bomb?

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

Introduction

When businesses are formed or reorganized, the shareholders or partners are typically consumed with the endless challenges of building the new company. In the midst of this growth, they sign shareholder agreements that seem fair and practical for what they have just created.

Over time, however, individual shareholder circumstances, their involvement in the business, and business conditions often change. These changes can affect the value of the company on a whole, the value of their individual ownership interests in the company, the value of their individual contributions to the company through their work, and shareholders' perceptions of each others' value.

In this dynamic environment, a shareholder may want to sell out, may get divorced or become disabled, or even die. At this critical time, they need a shareholder agreement that is clearly worded, and that meets their current circumstances and needs.

When the agreement fails that test, the parties' recourse is often litigation, and this

route frequently causes distraction from business needs, significant professional fees, and hard feelings. There are, of course, ways to avoid this pain.

Shareholder and partnership agreements commonly include stipulations as to how the value of an interest is to be determined in the event a shareholder or partner wishes to leave the enterprise, or in the event of disability, divorce or death. The valuation stipulations, if written without the input of a business valuation expert, could suffer from inadequate and unclear references to valuation. Examples of the need for clarity include:

- ◆ If a minority interest is involved, is it to be valued with a minority discount or is it to be the value of 100% of the company prorated to the percentage owned?
- ◆ If book value is specified, is it to be as shown on the company's balance sheet or are adjustments to be made to recast assets and liabilities at market values instead of book values? (Book values are commonly much lower than market values.)

(Continued on page 2)



KNOW WHEN TO GET OUT

" The life expectancy of many smaller companies is growing shorter as today's fast-moving economy produces opportunities and then almost immediately begins destroying them.

That means increasingly entrepreneurs need to quickly enter a market, exploit it as fully as possible, and then be prepared to get out before profit margins become too narrow to support the business.

What's driving the trend? The strong downward pressure on prices that global and technological competition brings is collapsing profit margins across many industries, leaving fewer crumbs for small companies to capture."

- from the article "*Pressure Increases to Make the Money and Run*", Wall Street Journal, Jan. 14, 2003

(Continued from page 1)

- ◆ If earnings are referenced, are they to be as shown on the company's income statement or adjusted to reflect true economic performance? It is not uncommon for the earnings of a private company to be managed to minimize taxable income. Is this fair and equitable for determining the value of the interests of individual shareholders or partners?
- ◆ The value determined by such an agreement could force a shareholder or partner (or their estate) to sell their interest back to the company or to the other owners at a price which is much lower than the value which must be assigned under IRS regulations to that interest when filing a tax return to settle the estate!
- ◆ Since the shareholder agreement was written, have separate entities been formed to own and lease assets, such as buildings, equipment or other items, back to the company? If so, these assets will not appear on the balance sheet of the company and, therefore, could be excluded when the value of an ownership interest in the company is determined under the agreement written years earlier.

At the inception or the reorganization of a business when these agreements were signed, all was expected to go well, so these and other critical valuation issues are often not annually addressed. Failure to clarify these issues greatly increases the prospects that when the agreement is needed, it will fail you and contribute to the prospects of litigation. Don't wait for this time bomb to explode in your company. Have your agreements reviewed and updated to reflect current shareholder and company circumstances.

What Makes Maximizing Return on Investment in a Private Company So Difficult?

Does your overall investment plan include a strategy to maximize your return on the stock you own in your private company? Surprisingly, many private company owners fail to include this asset, which is often the largest, riskiest and least liquid security in their portfolio, in their investment plan. Failure to view your private company as an investment can threaten your and your family's long-term financial security.

Because the stock of a privately held company is not traded on a public exchange, this unique investment differs from other assets in your portfolio in the following ways:

- Middle market private companies, because of their smaller size, tend to be much more volatile and risky investments than the large cap public company stocks that most investors own. To compensate for this higher risk, private companies must generate higher rates of return.
- Middle market private companies are often family businesses in which shareholders have much or most of their wealth concentrated. This prevents the portfolio diversification that prudent investors seek for safety.
- Business owners annually pay CPAs and attorneys

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to minimize their company's income to avoid taxes. This often disguises the company's true performance and sometimes causes shareholders to overlook the fact that higher income generally maximizes the company's value.

- In private companies, shareholders often assume some measure of the company's income is their return on investment. In reality, your true return is the **cash** you can withdraw from the business after paying all expenses and taxes and funding the company's continuing need for working capital and fixed assets. This amount of cash is not reported on financial statements or tax returns, so investors fail to focus on it or compute their true return on investment.
- Without a known stock price, the value of a private company is much harder to measure, manage and harvest. Investments generally must be sold to produce their maximum potential return, and selling at the right price and terms requires you to know your company's value – and what drives it.
- Without a stock market in which to trade your private company stock, liquidating your investment can be

"The annual valuation reminds owners that their private company, like all of their investments, can increase or decrease in value. So there is a time to hold that stock and a time to sell it."

difficult, time consuming and expensive. This means advanced planning to achieve the best market conditions, price and terms is a must.

- **Minority** shareholders who lack control over corporate policy frequently realize no cash return on their investment. Dividends are seldom paid because of unfavorable tax consequences and there is seldom any market in which to sell minority shares. As a result, minority interests in private companies generally carry a steep discount from the value of the controlling interest in that business.

One possible conclusion to the points listed above: Avoid investment in a private company.

While E&A does not advocate this investment strategy, we strongly advocate that private company owners include their business in their investment strategy. This process begins by recognizing that your private company is an investment that should create value for you and your fellow shareholders.

"...we strongly advocate that private company owners include their business in their investment strategy."

That value can come to you only by harvesting cash from the business each year as dividends or excess salary and benefits or through sale of the business. (Your market level salary and benefits are a return on your *labor*, not your *investment*.)

Wise owners constantly monitor their private company investment by having the business valued each year. In the process, they can continually focus on what drives risk and value in their company. With this focus, owners are more quickly aware of changing market or competitive conditions that may threaten the company - and their wealth.

Finally, the annual valuation reminds owners that their private company, like all of their investments, can increase or decrease in value. So there is a time to hold that stock and a time to sell it.

Successful sale of a private company requires careful preparation. To get the best possible price and terms, you must find qualified buyers and effectively present your business to them. Obviously, this process is far more complicated than calling your broker to order the sale of your IBM stock.

Complicated, but not impossible. The key first step is to recognize your business as an asset in your portfolio and then manage it to build your wealth. Annual valuations provide the critical information needed to manage this unique asset. Armed with this data, shareholders can then plan their future, manage their risk, and maximize their wealth. Evans and Associates can get you immediately started on this road to wealth building.

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When your circumstances require measurement or management of business value, our focused approach provides solutions.

Our team's expertise in competitive analysis, finance and accounting, merger and acquisition, risk analysis and value creation forms the basis for our opinions and advice.

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