

PO BOX 655
1 EAST STATE ST
SHARON, PA 16146

(724) 346-0150

EVANS AND ASSOCIATES

VALUATION ADVISORY SERVICES

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.

Six Keys to Private Company Payoff

Many investors today are relieved that they avoided two fundamental mistakes made by many Enron investors and employees: Failure to properly assess the risk of their Enron stock, and failure to diversify that risk. Unfortunately, for many private company investors, this sense of relief is misplaced.



Over 99% of all companies are private, and for this huge class of investors, their business is often the most valuable asset in their portfolio. Yet they routinely underestimate their private company's risk, and concentrate too much of their total wealth in this volatile stock. Private company owners should treat their business as an investment, and manage it to build value.

Public companies receive daily market feedback via their stock price as a gauge of investor perception of their performance, prospects and value. With no known stock price, value creation is much more mysterious for private companies. Because so many businesses are privately held and most merger and acquisition targets are private companies, buyers and sellers must understand what creates and destroys value for private firms. The following are six guidelines to help

private company owners and buyers manage their wealth building process in the absence of a known stock price.

1. **Value is in the eye of the beholder.** Value depends on your perspective: Many private firms are worth more to a strategic buyer than as a stand-alone business. Therefore, maximizing the owners' return often means *positioning* the business to sell at the best time to the best buyer to get the best price.

The cold reality is that private companies are usually highly risky, illiquid investments for which there tend to be few buyers who are both interested and qualified. Preparation and timing for a sale can be critical – a motivated buyer with big potential synergies or new economic or industry conditions could emerge suddenly.

Wise owners continually monitor potential synergies and buyers. The higher strategic value such a buyer could create should become a key factor driving the company's strategic plan. When the owners cash out at an opportune time, they can reinvest their pro-

"When the owners cash out at an opportune time, they can reinvest their proceeds to achieve two essential investment objectives: the liquidity and diversification they previously lacked."

(Continued on page 2)



Does Growth Automatically Create Value?

Many shareholders and corporate executives are surprised to learn that value is not automatically created when a company increases its revenues or assets. Increased size does not necessarily lead to greater cash returns or reduced risk. Even profitable growth generally requires cash investments for working capital and fixed assets, both of which reduce the company's expected net cash flow. Therefore, growth increases value only when it reduces risk or creates positive net cash flows, after consideration of capital reinvestment requirements.

(Continued from page 1)

ceeds to achieve two essential investment objectives: the liquidity and diversification they previously lacked.

2. **Buyers must distinguish between a good company and a good investment.** A target's weaknesses reduce its value – and should reduce its price – as a stand-alone company. For the strategic buyer who possesses key competencies the target lacks – for example, an effective distribution system, management depth or an emerging technology – the sellers' weaknesses may enable the buyer to acquire a significant value-enhancing opportunity at a good price. Conversely, a strong target that commands a high price may be a good company but a poor investment because the high acquisition price creates little opportunity for the buyers to build and harvest value – the sellers got it all.

“..a strong target that commands a high price may be a good company but a poor investment because the high acquisition price creates little opportunity for the buyers to build and harvest value—the sellers got it all.”

3. **Investors value cash, not revenue or Ebitda.** To accurately assess value, compute the company's *net cash flow*, which means allowing for reasonable company needs for taxes, fixed assets and working capital. Describing Ebitda (earnings before interest, taxes, depreciation and amortization), as a company's true return can be as misleading as claiming employees can spend their gross, rather than net, pay.

Value should be based on *future* cash flows, not the past. So forecast the company's net cash flow for at least five years, both as a stand-alone business and with the estimated synergies that could be created by the strategic buyer. With these forecasts, variations in anticipated growth and their effect on both stand-alone and strategic values can be calculated.

4. **Beware of multiples – they frequently distort value.** To claim a company should sell at some multiple of last year's earnings or revenues ignores several critical facts. First, last year's performance may reflect unique conditions, and the future is likely to differ from the past. Further, any multiple of a single year's performance cannot accurately reflect future growth expectations – fast or slow – and growth is always a key value driver.

For more accurate estimates of value, adjust for greater risk by discounting with a greater cost of capital, not by using a smaller multiple. Calculating the present value of the forecast of net cash flow with the proper cost of capital provides the discipline for an accurate estimate of *both* stand-alone and strategic values. Applying a multiple to revenue or Ebitda is easy, but the cost of this shortcut is too great for any thoughtful buyer or seller. The correct approach requires disciplined development of appropriate rates of return to reflect the investment's risk. The reward is accuracy, and an increased likelihood of building value.

5. **Recognize poor financial performance destroys value.** Besides tangible assets, most companies possess

(Continued on page 3)

(Continued from page 2)

intangibles – technology, people, processes, customers, and reputation. *But few create value from them.* When private companies produce net cash flows that are inadequate for the investment and level of risk taken, they destroy value instead of creating it – and because their stock price is unknown, they don't even realize it. These owners should get only fair market value for tangible assets, and little or nothing for their company's "goodwill" because under their management it created no value.

Owners of under-performers have three choices:

- Raise the company's rate of return through strategies that reduce the required capital investment, reduce risk or raise net cash flow.
- Sell the company and reinvest the proceeds elsewhere.
- Continue to earn an inadequate return.

"Too many owners miss great opportunities to sell their company by exclusively demanding a specific price. Such inflexibility can cost them a fortune."

Far too often, owners make the third choice, and end up like the Enron employees, with too much of their personal wealth concentrated in single, volatile investment.

6. *In a sale, focus on your true cash return, not price.*

Too many owners miss great opportunities to sell their company by exclusively demanding a specific price. Such inflexibility can cost them a fortune. The deal structure – asset versus stock – and payment terms – cash or stock or notes – greatly influences the buyer's risk and cost and the sellers' return. Wise buyers and sellers continually focus on the deal's *net after tax payments and proceeds* rather than on a price. Employment or consulting contracts, royalty payments, and earnouts – terms beyond the price – are just a few of the ways to improve *both* the buyer's and sellers' risk and returns. Often the real key is to minimize the return to the uninvited third party in every deal – the government. To accomplish this, recognize how all aspects of the deal affect all three parties – and negotiate accordingly.

Conclusion

Too many Enron investors paid an enormous price to learn why concentrated investment in a volatile stock is a flawed strategy. The same peril looms for a far greater number of private com-

pany shareholders and buyers. Wealth can and should be created through private company ownership. But the odds of success are greatly enhanced when investors clearly understand what value is and how to build it, and how to manage the unique challenges of investment in a private company.

*This article was adapted from
"VALUATION FOR M&A:
Building Value in Private
Companies" by Frank C. Evans
and David M. Bishop,
published by John Wiley &
Sons, 2001.
www.wiley.com*

FIRST STEPS

To manage your business as an investment and take control of your life:

- Retain qualified valuation advisors to lead the process.
- Identify and prioritize your personal and financial goals.
- Quantify
 - Your company's return
 - Your company's risk
 - Your company's worth
 - Your company's return on investment

RESULT:

Armed with the information, you can devise the best strategy to achieve your business, personal and financial goals.

Reproduction is prohibited without permission..

EVANS AND ASSOCIATES

VALUATION ADVISORY SERVICES

P.O. Box 655
One East State Street
Sharon, PA 16146

Phone: 724-346-0150

Fax: 724-342-4510

fevans@evansandassociates.net



Frank Evans
ASA, CBA, CPA/ABV
fevans@evansandassociates.net

Visit us on the Web!
www.evansandassociates.net

Shop Carefully for Valuation Expertise

Just as patients seek specialists for serious medical conditions, specialized qualifications are required in business valuation. Some credentials presented by so-called experts actually demonstrate no knowledge of business valuation. Others require little or no testing, work product review or experience to achieve.

Evans and Associates invites close scrutiny of our credentials. We have demonstrated the highest level of achievement in our profession, and are active locally and nationally in writing, speaking and governance. This expertise clearly results from our strategic focus and full-time commitment to comprehensive business valuation knowledge and service. Evans and Associates' credentials can be reviewed in detail at www.evansandassociates.net

Our Mission

Evans and Associates is a leading provider of strategic valuation advisory services. We maximize wealth and profits for individuals and corporations. 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.

Typical engagements for Evans and Associates include specialized valuation consultation for the purpose of gift or estate planning, merger and acquisition, shareholder value enhancement and litigation support.

Evans and Associates Partner Credentials Include:

Accredited Senior Appraiser
Certified Business Appraiser
Certified Public Accountant Accredited in Business Valuation

Personal Attention Backed by a Network of National Resources

Evans and Associates is a specialized valuation advisory firm small enough to provide the personal attention you want, but deep enough to possess the broad range of service expertise you may need. Our membership in the American Business Appraisers (ABA) national network— we were the founding affiliate member—provides resources and advice from other nationally known valuation experts. Our ABA affiliation enables us to effectively execute virtually any valuation or merger and acquisition assignment.

