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ROUTE TO:

VALUE ADDED™

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Valuation Implications of Valuing a Business Using a Measure Other Than Net Income or Net Cash Flow

In this article we consider the implications of valuing a business based on something other than net income or net cash flow. Most people can understand pricing a business or a piece of a business based on net income or net cash flow because that is truly the portion of the income stream that is left-over, or residual, profitability which could, at least in theory, be paid to shareholders as dividends. The value of any business is most simply defined as the present value of shareholder level cash flows (dividends and the terminal value when the interest is sold). But some valuations are prepared on the basis of something other than the present value of net income or net cash flow. What accounts for this?

Leaving aside, for the purpose of this article, the topic of balance sheet values, appraisers often find themselves compelled for one reason or another to value a company on some other basis than net profits. Commonly, one might look at EBITDA (Earnings before interest, taxes, depreciation and amortization), EBIT (Earnings before interest and taxes), or OCF (operating cash flow, defined as EBITDA minus capital expenditure requirements). Only slightly less commonly, appraisers might define value in terms of gross profit or even revenue itself. Of course, there are also various rules of thumb and activity valuation measures that are outside the scope of this article (price per access line for a telecommunications company, price per bed for a nursing home, price per unique user for an internet company, etc.).

Valuation on these bases is somewhat confusing, because none of these measures (EBITDA, EBIT, OCF, gross profit, revenue) represents the true dividend paying capacity of a company. They are a step along the way, however, and therefore often reasonably receive considerable attention in valuation. The choice and use of these measures of value depends, at least, upon 1) the level of value appropriate for the assignment, 2) the company itself, and 3) the industry in which the company operates.

Different Levels of Value: Different Valuation Indications. Is the valuation being prepared on a minority interest basis or a controlling interest basis? If the valuation is being prepared on a minority interest basis, these other indicators of value should be used with great caution.

If control is the issue, an appraiser can take more liberties. Why? Net income and/or net cash flow, depending upon which is most applicable, represents the residual income

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Litigation Update

When to Call in a Business Appraiser

There is no doubt that valuation advisory services provide the peace of mind and thoughtful documentation required to conduct those once-in-a-lifetime transactions that may be scrutinized by tax collectors, regulators, courts, and a myriad of other lurking adversaries. Good advice is to plan to avoid negative surprises and to protect a closely held business asset from being spirited away in a cash crunch that accompanies death, retirement, change in ownership, or a similar disruption.

Compliance issues (tax, regulatory, and legal/fiduciary compliance) trigger many needs for qualified, independent valuations of closely held securities. The familiar gift, estate and income tax issues relate to minority interests, discounts for lack of

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10/29/03 Minnesota Society of CPAs

Maximizing the Value of the Privately Held Company

11/03/03 International Business Brokers Assn.
Las Vegas, NV

Advanced M&A Tax Strategies and Deal Structures

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available to shareholders after accounting policies are set, capital items are funded, taxes are paid, etc. Valuing a business on the basis of such a residual income measure offers the potential to represent the value of a company to its shareholders without regard to their ability to influence any of these issues.

Since minority investors cannot unilaterally influence capital structure, revenue recognition methods, inventory

accounting, and other entries above the net income line, residual profits have a particularly important meaning. Valuing a company on the basis of, say, operating cash flow (EBITDA minus capital expenditures) implies assumptions about accounting policies with regard to depreciation and amortization, the amount and type of interest bearing debt used to finance capital expenditures, discretionary tax issues, and the level of capital spending. Lots of those issues interact, of course, but, even laying that aside, a minority investor simply does not have the opportunity to affect those issues which effect value. So, an appraiser valuing a minority interest using OCF has to either accept things as is (making no adjustments), or perhaps assume certain normalizing adjustments that would arrive at a value of a well-run as-if-publicly traded company (the classic definition of a marketable, minority interest basis of value).

All in all, a controlling interest buyer has more opportunity to manipulate the structure of a company's finances to influence value than does a minority investor. The difference becomes apparent when one tries to value a particular stream of operating cash flows by developing a weighted average cost of capital (or WACC). Modeling a WACC requires three primary inputs, the cost of equity, the cost of debt, and the proportion of equity to debt. A strategic acquirer might model their weighted average cost of capital using their costs of debt and equity, which might be considerably lower than the target company's might be on a stand-alone basis. If an acquirer is willing and/or able to increase the proportion of leverage in a subject company, it can generate higher returns and/or a higher valuation (at least up to a point). A minority investor, on the other hand, can only consider the existing company's cost of debt and equity "as-is", and the proportion of the capital structure financed with debt and equity "as-is." A well-run private company will generate a WACC that is optimal, and thus the marketable, minority interest value may be very close to that of a controlling interest value, at least to a financial buyer.

Choosing Valuation Metrics Based on the Company Itself. In addition to considering the level of value, choosing which valuation metric best describes the value of a company can often depend upon the company itself. Is the company capital intensive? Is it over-leveraged? Is it under-leveraged? Is it development stage? Is it reinvesting heavily to fund more rapid growth? Importantly, is it any of these things relative to its peers? If a company is being valued even on a minority interest basis, and it is, say, over-leveraged relative to most publicly traded companies in its industry, then valuation on a debt free basis can help to normalize some of that differential. The only danger here is that it is easy to understate the risk borne by minority investors in an over-leveraged company, because their subordinate position exposes them to a very high degree of volatility of returns.

What if a company is development stage? In general, it is safe to say that developing companies generate sales first, then gross profits, then operating profits, and then net income, and maybe only then net cash flow. If a company is a new entrant to a relatively mature industry, it may have value based on strong sales or gross profits even though it has not yet generated net income. The assumption here, of course, is that one day it will, in fact, have profits and margins similar to that of other more established companies and that a dollar of its sales will be worth an amount equivalent to a dollar of sales of another company. Of course, companies don't exist to make sales, they exist to make profits. So it's important to not be lulled into a false sense of security valuing tomorrow's net income today. There needs to be a reason to think that, ultimately, returns to shareholders will materialize.

Industry Valuation Metrics. Many industries have favorite rules of thumb and popular valuation measures which are far from net income or net cash flow. All of these seek to describe the value of some kind of activity in an industry that has unique meaning. Are

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Litigation Update

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marketability, intangible assets and the like. Many regulatory considerations relate to transactions with ESOPs and certain (re)financings, mergers, and acquisitions. Legal and fiduciary compliance issues stem from ESOPs, transactions that affect minority shareholders and practically any deal where a law requires "fair" treatment of parties who lack control. When it comes to addressing these compliance considerations, the benefits of valuation services are understood by practically all legal and financial advisors to business owners.

Moving beyond the typical compliance issues, valuation services can be extremely useful in the litigation arena. Undoubtedly, value is the centerpiece of much business and personal litigation. The high-stakes, hard-to-quantify issues of litigation are always aggressively challenged. In essence, an expert analyst should do three things essential to assessing any question of value, whether in a litigation or a compliance environment: focus on relevant information; draw conclusions that have economic substance; and, articulate the reasonableness of conclusions in a manner that appeals to common sense.

A business appraiser should be able to define the valuation issues, assemble the relevant information, and quantify the financial aspects of a case. Moreover, an expert should be able to communicate the soundness of conclusions convincingly.

Litigated issues are as diverse as the people involved and the problems that haunt them. These areas of litigation are the ones most likely to require the type of support that a business valuation professional can provide:

- **Divorce.** Controlling interests, minority interests, professional practices, partnerships, valuation of publicly traded and restricted securities.

- **Bankruptcy.** Postmortem analysis, going-concern valuations, reorganization feasibility assessment, fraudulent conveyance, forecasting.
- **Dissenting Shareholder Actions.** "Fair value" as defined in the various states.
- **Arbitration.** Review of opposing experts, negotiation assistance, range estimates of value.
- **Trial Support.** Critique of opposing experts, cross examination assistance, expert testimony, economic research, public securities, market and industry research.

Having a qualified business valuation expert on a litigation team can be a wise asset-protection strategy. Downside exposure is a problem for both plaintiffs and defendants. Please give us a call to discuss our litigation support services. ♦

Corporate Governance

An Update

On July 30, 2002 President Bush signed Sarbanes-Oxley into law. The SEC formulated rules to implement certain provisions of the Act while other provisions were effective upon enactment. On August 1 the NYSE approved revised listing requirements. These requirements were submitted to the SEC for final approval on August 16 and that approval is pending.

As business appraisers, we are keenly interested in anything that affects the public markets. Therefore, we highlight a few key issues of interest to our readers, summarizing first Sarbanes-Oxley and then commenting on actions (both final and pending) taken by the SEC as well as the proposed listing requirements of the NYSE.

Audit Committees

- **Independence.** Each member of the audit committee must be unaffiliated with the company and no member may accept any compensation from the company other than

for service as a director. The NYSE states that the company must have a wholly independent audit committee with at least three directors.

- **Audit Committee Financial Expert.** Requires that a company disclose whether it has at least one "audit committee financial expert" serving on its audit committee, and if so, the name of the expert and whether the expert is independent of management. A company that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert. On January 15, the SEC voted to adopt final rules implementing this provision. According to the NYSE proposed listing requirements, at least one member of the audit committee must have accounting or related financial management expertise.
- **Responsibilities.** Audit committees are made responsible for the appointment and compensation of the company's independent auditor and for oversight of the work of the auditor. Companies must authorize their audit committees to engage independent counsel and other advisers and to provide appropriate funding to compensate the independent auditor and its advisers.

Per the NYSE proposed listing standards, director's compensation must be sole payment for audit committee members and effective within six months of SEC approval, the audit committee will assume increased authority and responsibility including having sole authority to hire and fire independent auditors and to approve any non-audit relationship with auditors.

Professional Conduct for Attorneys

- On January 23, the SEC adopted the final rules implementing the provision that attorneys appearing before the SEC in the representation of companies shall be required to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company to the company's

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Corporate Governance

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chief legal officer and chief executive officer. The SEC is still considering the "noisy withdrawal" provisions and seeking additional comment from the public.

Auditor Independence and Regulation of Audits and Audit Firms

- *New Regulatory System.* A Public Company Accounting Oversight Board was created to regulate accounting firms in providing audit services to companies. Its members are appointed by the SEC which has oversight authority.
- *Prohibitions on Non-Audit Services.* In order to preserve its independence, a company's independent auditor (and any of its professional employees) are prohibited from providing:
 - bookkeeping or other services related to the accounting records or financial statements
 - financial information systems design and implementation

- appraisal services, fairness opinions or contribution in-kind reports
- actuarial services
- internal audit outsourcing services
- mgt. functions or human resources
- broker or dealer, investment adviser, or investment banking services
- legal and expert services unrelated to the audit

On January 22, the SEC adopted the final rules implementing this provision.

- *Permitted Non-Audit Service - Tax Service.* Section 201 of Sarbanes-Oxley specifically provides that "a registered public accounting firm may engage in any non-audit service, including tax services," that is not expressly prohibited, after audit committee preapproval. Accordingly, accountants will be able to continue to provide tax compliance, tax planning and tax advice to audit clients, subject to audit committee pre-approval requirements.

Sarbanes-Oxley set forth numerous other corporate governance rules that are beyond the scope of this article. For more information, visit the SEC's website at www.sec.gov. ♦

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Valuation Implications

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they useful? Yes. Are they conclusive of value? Hmm.

Beauty is in the eye of the beholder. A control-based strategic buyer with an existing platform in an industry may find more meaning in these valuation metrics than in any other. A financial buyer seeking a controlling interest should consider these valuation metrics in the context of their ability to create cash flow need to finance the capital structure. A minority investor can really only rely on these measures to the extent that they believe a company will be subject to acquisition by a strategic buyer.

Conclusion. In the end, earnings have become more fashionable, as have dividends. Those who knew the price of everything and the value of nothing are still licking their wounds. Appraisers need to keep in mind that, ultimately, value can only be described in the terms of some form of residual cash flow and a discount rate. ♦

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