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DARRELL V. ARNE, President
E-Mail: Darne@Arne-Co.com
Website: www.Arne-Co.com

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5424 Arabian Drive, NW
Albuquerque, New Mexico 87120
Telephone: (505) 898-2514 Telecopier: (505) 899-4476

Ten Easy Mistakes to Watch For In Business Appraisals

Recognizing the complexity of business appraisals today, there are a number of easy mistakes that professional advisors (attorneys, accountants and ESOP fiduciaries) can watch out for as they assist their clients through the valuation process. Accordingly, we will share the following points.

- 1. Does the Math Check?** Today's Excel worksheets provide great facility for changing the numbers as the analysis changes, but can also introduce a different type of error. If the cells in a worksheet are not properly linked, a change in one area may not carry through correctly. A quick check of the math will reveal if the numerator is divided by the proper denominator; if a percentage rate is properly converted to a multiple; or if a column of figures adds up.
- 2. Valuation Date Agreement.** Does the valuation date agree with the transaction date, gifting date, or date of death, or is it stuck to the date of the most recent financial statements? Given the timing for production of financial statements, it is likely that today's current report will be based on financial statements that are 2 - 3 months old. However, given a current meeting with management, analysis of current events, including interest rates and guideline studies, the analyst can utilize reasonably historical financial statements, but the valuation date should tie to a specific current date required by the client.
- 3. Underlying Earnings Power.** Does current, underlying earnings power, determined by the analyst, confirm the respective margins and earnings indicated in the projections provided by management? Historical earnings often provide a prog-

By following these few benchmark items, professional advisors and fiduciaries can work with and challenge the appraiser to provide an accurate and comprehensive work product

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Financial vs. Strategic Buyers

The terms "Financial Buyer" and/or "Strategic Buyer" frequently arise in discussions about investment banking activities, particularly when discussing the sale of a business. This article describes some of the characteristics of each type of buyer, and briefly discusses potential situations in which one might be more appropriate than the other.

Financial Buyers. Financial buyers can generally be classified as investors who bring financial resources to a transaction, but little or no business synergies. They are interested in the cash flow generated by a business and the future exit opportunities from the business. They are typically individuals or investment firms. Their goals may include growing cash flow

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nosis for future financial performance. However, in a cyclical business, current favorable earnings may not be reflective of ongoing earnings power. If management has provided financial projections, the implicit earnings should reasonably confirm the analyst's assumption of ongoing earning power used in say, the capitalized earnings approach or a guideline company approach.

4. **Large Swings in Cash Flow.** Unusual financing situations, such as the sale of stock, incurring long-term debt or purchase of a new operating facility can imply large and unusual swings in cash flow in a given year. These variations can greatly impact a discounted cash flow model if the major changes in cash inflow are not properly matched against the major changes in cash outflow.
5. **Guideline Companies.** The fourth edition of *Valuing a Business* [Pratt, Reilly and Schweihs, McGraw Hill, 2000] describes the criteria for Guideline Company Selection. There are many companies to choose from but the selection can be difficult. The text mentions several court-directed factors to consider, including: Capital structure; Credit status; Depth of management; Personnel expertise; Nature of competition; Maturity of the business; Products; markets; Management; Earnings; Dividend-paying capacity; Book value; and Position of the company in the industry. Revenue Ruling 59-60 has very general guidelines for comparability. Nonetheless, it is clear that the typical closely held company with \$5 - 10 million in revenues may not be very comparable to far larger and more diversified public companies.
6. **The Build-up Capitalization Rate.** Many analysts rely upon an appraisal method that capitalizes ongoing or underlying earning power at a rate determined by the "build-up" method. The method has as its base, long-term Treasury bonds, to which are added various premiums for equity security risk. The equity premiums are typically based on studies performed by Ibbotson & Associates, and it is important to understand that these premiums are in turn based on market studies of public stocks. Those shares of public companies are, by their nature, minority interests. The analysis should explain how the derived capitalization rate properly applies to the subject interest, or provide some adjustment for a controlling interest, if needed.
7. **Does the Answer Conform to Ownership Interests?** There are various forms of security ownership, and the appraisal answer should conform to the appropriate ownership interest: per share for a stock interest; per unit for certain Partnerships and Limited Liability Companies; percentage interests for certain other Partnerships and LLC's; or, Members' Interests of LLC's in general.
8. **Dividends From Sub Chapter S Corporations.** S Corporations combine the limited liability features of a corporate entity with the income pass-through attributes of a partnership. As such, S Corporation stockholders are liable for the taxes on the company's income, whether it is distributed or not. Dividend capacity is a key analytical factor to consider, but may be distorted due to the relatively large dividends paid by S Corporations.

To make a fair comparison to the investment returns of C Corporations, the S Corporation dividend must be converted to its C Corporation equivalent, to determine if there is a real, economic dividend, or if the dividend is only sufficient to cover the implicit tax liability.

9. Text and Worksheet Agreement.

Most analysts will prepare and finalize the worksheets that accompany the text of an appraisal report before completing the text. Changes can occur during the writing process and the reviewer of the report should ensure that the text properly references key worksheet benchmarks in the development of the analytical story.

10. Analytical Replication.

The reader of an appraisal report text should be able to replicate the analysis presented in the worksheets, based on the numbers, averages, medians, adjustments and percentages provided. The analytical conclusion, typically selected from a range of indicated values, should provide the rationale for the selection process and the rationale should validate the risks and opportunities discussed previously in the report.

In summary, as the business of business appraisal has matured, analytical tools and techniques have mushroomed, supported by database and computer resources that can now make for a complex and challenging appraisal report. By following these few benchmark items, professional advisors and fiduciaries can work with and challenge the appraiser to provide an accurate and comprehensive work product. If you would like to discuss a valuation project in confidence, please give us a call. ♦

Financial vs. Strategic Buyers

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through revenue enhancement, expense reductions, or creating economies of scale by acquiring other similar companies. Their exit plans may include an initial public offering, where the business is "taken public" (hopefully at a higher multiple of earnings than paid in the acquisition), or selling the company at a future date.

Financial buyers carefully scrutinize the financial statements of the company. Most look for a well-managed company with a history of consistent earnings, and preferably, earnings growth. The transactions of financial buyers are often leveraged. It is common to see financial buyers use as much as 80% or more debt to finance an acquisition. By using high levels of leverage, the financial buyer is effectively partnering with someone who is willing to accept a level of return (a lending rate, perhaps augmented by "kickers" to enhance returns) that is generally lower than that required by financial buyers.

In layman's terms, financial buyers are buying exactly what the company has to offer. They are buying the expected future earnings of the company as they are perceived to exist at the time of the acquisition. While financial buyers may see the potential for expanding cash flow beyond what the company has achieved on its own, they are generally not willing to pay

for that potential. They are much more likely to keep the current personnel in place than strategic buyers. However, if their intent is to grow the business and eventually sell to a strategic buyer, the retention of personnel may be temporary.

Strategic Buyers. Strategic buyers are interested in a company's fit into their own long-term business plans. Their interest in acquiring a company may include vertical expansion (toward the customer or supplier), horizontal expansion (into new geographic markets or product lines), eliminating competition, or remedying some of its own key weaknesses (technology, marketing, distribution, research and development, etc.).

Strategic buyers are often willing and able to pay more for a company than financial buyers.

There are two main reasons for this. First, strategic buyers may be able to realize synergistic benefits almost immediately due to economies of scale that may exist through the combined purchasing power of the new entity and the elimination of duplicate

functions. The better the fit (i.e., the more realizable the synergies are), the more they will gain from the business and the greater the premium they will be willing to pay. Second, strategic buyers are generally larger companies with better access to capital. They often have another currency available to them in the form of stock. Strategic buyers often offer stock, cash, or a combination of the two in payment of the purchase price.

Financial buyers can generally be classified as investors who bring financial resources to a transaction ... [while] ... strategic buyers are interested in a company's fit into their own long-term business plans

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In short, the strategic buyer is buying the company in light of how it will enhance their existing operations. They are often willing to pay for readily realizable synergies, and many times will pay for speculative synergies, particularly if the target company is being marketed to other competitors (through some type of “auction”). Strategic buyers are much less likely to retain all of the current personnel.

Which Is Right? Believe it, or not, the answer to the question “which is right?” is not always as cut and dried. Whether a strategic buyer or a financial buyer is right for a specific company depends largely on the seller’s goals in selling the business. Listed below are different scenarios discussing the seller’s goal and the type of buyer most appropriate.

- ***The Seller Wants the Highest Price Possible.*** If the only goal in the sale is achieving the highest price possible, regardless of what happens to the plant or employees, the open auction process is the best way to drive

the price upward. And obviously, with highest price being the only goal, the strategic buyers will most likely be the best fit. That is not to say that financial buyers should not be considered in the process.

Whether a strategic buyer or a financial buyer is right for a specific company depends largely on the seller’s goals in selling the business

- ***The Seller Wants a High Price, but Has Other Concerns.*** If the seller’s goal is a high price (not to be confused with “highest” price), but the seller wants to protect employees, a strategic buyer is still probably the most appropriate. However, the seller needs to realize that there will need to be concessions made from the highest price in order

for the acquisition to work for the buyer.

- ***The Seller Wants to Cash Out, but Would Like to Remain for a Few Years.*** In this situation, a financial buyer is probably most appropriate. The owner/manager is often times the most readily realizable synergy for a financial buyer. Strategic buyers generally have the expertise necessary to operate the business, and can eliminate the money that is being paid to top level management. More and more deals are being structured where part of the consideration paid is tied to an “earn-out” where the seller will receive additional money if certain, predetermined goals are achieved in the first few years following the sale.

This brief discussion is in no way intended to try to address all of the circumstances that may need to be considered in the prospective sale of a business. ♦

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