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Business Valuations • Mergers & Acquisitions • Seminars

ROUTE TO:

VALUE ADDED™

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Business Valuation Bootcamp for Attorneys

Often an attorney will ask us a very simple question about business valuation in the context of attorneys and business appraisers working together –

“What can I do?”

The clear implication of the question is how can attorneys improve their practical knowledge of business valuation without becoming “technicians” themselves. This article contains a few suggestions that should be helpful for attorneys when working with appraisers.

Understand the Assignment Definition

Every valuation should be viewed from two perspectives that act as “bookends”: (1) assignment definition and (2) a relative value analysis that permits you to begin with the end in mind. Assignment Definition is critical since it creates the road map and framework for the report.

An *omission* of critical information can make it difficult or even impossible to understand a valuation report or assess its validity. Keep in mind that errors of omission are often the hardest to detect. In our experience we have seen errors that are worthy of special mention.

- **The Standard of Value** must be explicitly defined. The standard of value has a definition and often invokes a set of laws, regulations, or court decisions that further define the “ground rules” of the assignment.
- **The Premise of Value** (or sometimes called the Level of Value) is essential. The reader should know from the outset whether or not a minority interest or controlling

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When Down Is Not Necessarily Down

A Closer Look at the Recent “Decline” in Acquisition Multiples

Acquisition multiples are down substantially compared to historical levels. This most recent negativity is actually part of a longer downward trend that began in the 1998-1999 period. Chart 1 on page 3 outlines the average EBITDA multiple paid in deals announced from 1996 through 2001 (S&P Portfolio Management Data, M&A Today, June 2001).

As is typical, acquisitions of smaller companies have been priced at even lower average multiples when com-

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Darrell V. Arne Future Speaking Engagements

Business Valuation for Bankers

03/14/02 New Mexico Chapter of RMA
Albuquerque, NM

Maximizing the Value of the Closely Held Company

03/14/02 International Business Brokers Assn.
San Francisco, CA

05/02/02 International Business Brokers Assn.
Chicago, IL

07/18/02 Alliance of M&A Advisors
Chicago, IL

11/11/02 International Business Brokers Assn.
Los Angeles, CA

Tax Boot Camp for the M&A Professional

03/15/02 International Business Brokers Assn.
San Francisco, CA

05/03/02 International Business Brokers Assn.
Chicago, IL

06/11/02 International Business Brokers Assn.
New Orleans, LA

Advanced M&A Tax Strategies and Deal Structures

03/15/02 International Business Brokers Assn.
San Francisco, CA

Succession Planning: Exit Strategies for the Privately Held Company

06/10/02 International Business Brokers Assn.
New Orleans, LA

11/07/02 American Institute of CPAs
Souix Falls, SD

12/05/02 American Institute of CPAs
Jackson, MS

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interest is being valued. It should not be left to the reader to conclude this by looking at the valuation methods employed. Furthermore, it should be no surprise that two appraisers would reach widely different conclusions of value if the Premise of Value was different.

- **The Effective Date** of the valuation, sometimes referred to as the “as of date,” is obviously critical because it drives the selection of financial information, market information, and industry data. The Effective Date can be in question, particularly in divorce matters, therefore careful attention is warranted. Keep in mind that there may also be multiple effective dates.
- **The Scope of Work** must be defined. Understand the scope of work as defined by the professional standards of the group to which your appraiser is affiliated. Ask for the professional standards of your appraiser and the opposing expert and then make a common sense comparison of the requirements of the standards to the actual work performed.

Begin with the End in Mind – Sometimes Called Relative Value Analysis

Every valuation report should include a relative value analysis. Examples could include, but not be limited to, a price/earnings ratio, price-to-book value, price-to-net assets, and total market capitalization-to-EBITDA. The purpose of the relative value analysis is to demonstrate the reasonableness of the conclusion of value. It should not be up to the reader to prepare it.

Furthermore, these calculations provide a terrific check and balance.

The conclusion of value must meet the tests of common sense and reasonableness. Even if every assumption in the valuation seemed reasonable, the end result may not be. Find or create the relative value analysis, which allows reasonable people to evaluate the conclusion.

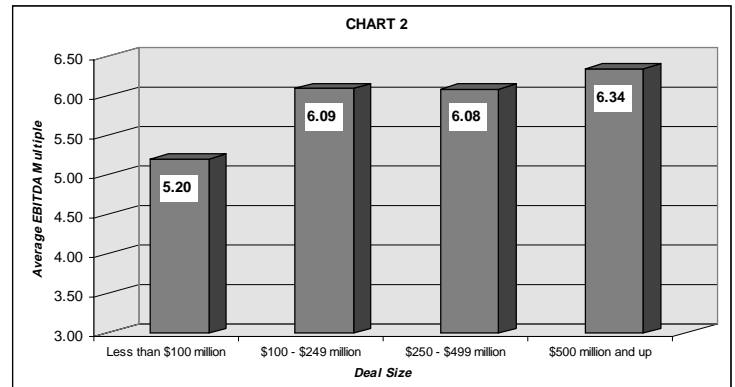
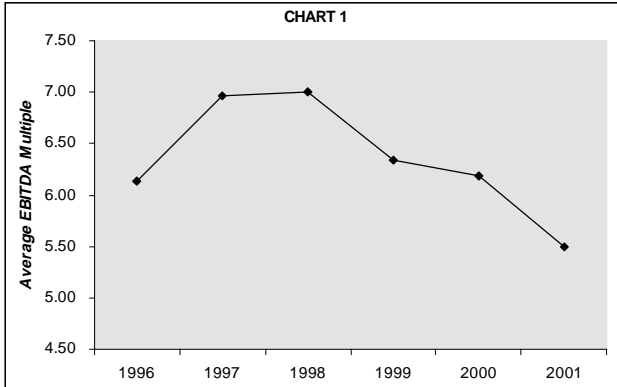
Do not assume that your appraiser is familiar with all the rules of evidence in any litigated matter

Carefully Explain the Rules of Evidence and Testimony to Your Appraiser

Do not assume that your appraiser is familiar with all of the rules of evidence in any litigated matter. From our lay person’s perspective the rules seem to be different between jurisdictions and based upon the type of litigation.

- If litigation has ensued or can be reasonably anticipated, then think in advance about the work product you will need. For example, direct testimony in the Tax Court is the written report. Does it tell the story clearly and completely?
- As the trial approaches, speak with your appraiser about rules for talking with other witnesses. Alleviate any anxiety by planning carefully the process of the trial. Don’t wait for the judge to ask the appraiser to leave the courtroom to get organized. Remember that appraisers are not as familiar with your world of the courtroom.
- Ask your appraiser if any valuation methods have been used which might be perceived as outside the mainstream of general practice.

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When Down Is Not Necessarily Down

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pared to the entire group (see Chart 2). During the six months ended March 31, 2001, the average EBITDA multiple for acquisitions with a total deal size of less than \$100 million was 5.20x (S&P Portfolio Management Data, *M&A Today*, June 2001). For even smaller acquisitions, the average EBITDA multiples over the most recent period have probably been closer to 4.0x-4.5x.

What does this data tell us? Is it doom and gloom for business owners that may be looking to sell? Certainly the picture is not all rosy, but it's not *that* bad either. It must be remembered that all investments should be considered within the context of other alternative investments. The value of a certain business may be lower today than it was two years ago, but the value of most companies across the board, including those traded on the public markets, are also lower.

An example should be illustrative. Consider that there are two business owners (we can call them Owner 1 and Owner 2) who each own 100% of perfectly identical companies. For simplicity, we will say that each company has had stable annual EBITDA of \$5,000,000 over the past three years.

On January 1, 2000, a financial investor approaches both business owners and offers to purchase each company for cash based on a multiple of 5.5x EBITDA, or \$27,500,000. Owner 1, feeling this offer is adequate, accepts and receives \$27,500,000 (in this hypothetical world there are no taxes). After much consideration, Owner 1 decides that active trading is not efficient over the long term, so he invests all of his money in an S&P 500 Index Fund. (Of course, most reasonable investors would look for additional diversity, but we are trying to make a point, so bear with us.)

Alternatively, Owner 2 decides that it is not the right time to sell, and thus rejects the offer.

Therefore, Owner 1, essentially traded his company for \$27,500,000 invested in the S&P 500, and Owner 2, still owns his company with annual EBITDA of \$5,000,000.

Fast forward to November 1, 2001. Owner 1 still holds his investment in the S&P Index Fund, though he has

experienced a return of -27.5% during the interim period. Owner 2, on the other hand, has recently agreed to sell his company for a price equaling 4.5x EBITDA (down significantly from the 5.5x that he could have had less than two years ago). Who is better off between the two?

As seen in Table 1, Owner 2 actually comes out ahead. Even with the lower acquisition multiple, the total net worth of Owner 2 (assuming no other investments) exceeds that of Owner 1. Our point is, hopefully, clear. Acquisition multiples are down, but so is nearly everything else.

It is important that business owners who are either actively attempting to sell their company or planning to do so in the future have an accurate picture of the current acquisition environment. In the selling process, it is necessary to have a reasonable expectation of the price your business will command in the market. Without an accurate picture of the current conditions in the market, such reasonable expectations are difficult to develop.

It is dangerous, however, to be too pessimistic. Multiples are down, but there are opportunities for selling. In fact, considering the current public market environment, now may be an opportune time to look for liquidity. Selling for what historically may be a "cheap" price is a good deal when you can reinvest even "cheaper." ♦

	TABLE 1	
	OWNER 1	OWNER 2
	Company Sold on	Company Sold on
	January 1, 2000	November 1, 2001
EBITDA	\$5,000,000	\$5,000,000
EBITDA Multiple	5.5	4.5
Total Deal Price	\$27,500,000	\$22,500,000
Return on S&P 500 Index	-27.5%	↓
Total Net Worth Today	\$19,937,500	\$22,500,000

Business Valuation Bootcamp for Attorneys

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This will allow you to anticipate *Daubert* challenges.

Respond to Your Appraiser's Calls for Information

Adequate information is a pillar of a good valuation. Help the appraiser get that information if assistance is needed. Furthermore, stay in close contact with the appraiser as depositions and trials begin. We are aware that there are seriously conflicting demands on the time of litigators as these key events approach, however, we have also observed that some questions just cannot be answered on the eve of the event.

Check the Arithmetic

Your appraiser should carefully check the accuracy of all essential mathemati-

cal calculations in the report. We suggest that you don't trust it to chance, mistakes are very common.

Ask About Quality Control

This is best done when purchasing the valuation assignment; however it is also worthy of monitoring as the assignment unfolds. Consider the following questions:

- Was the report "reviewed" by anyone other than the primary writer?

The reader of an appraisal report should be able to follow a simple maxim – if you can't understand it, don't stand for it

- Was the math checked and were critical sources of information documented?
- Were any procedures or information compromised in the prepara-

tion of the report? If so, were the limitations properly noted.

Determine if the Report is Understandable

A valuation report should be clear about the sources of information, the critical assumptions, and the judgments employed. Leaps of faith, bold but unsupported valuation adjustments, and pure mystery should not be part of the product. The reader of the report should be able to follow a simple maxim – if you can't understand it, don't stand for it.

Conclusion

Remember that an attorney can do some very tangible things to ensure a quality appraisal product. We hope these practical steps will help your work with business appraisers. For more information or to discuss a valuation issue in confidence, please do not hesitate to call us. ♦

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