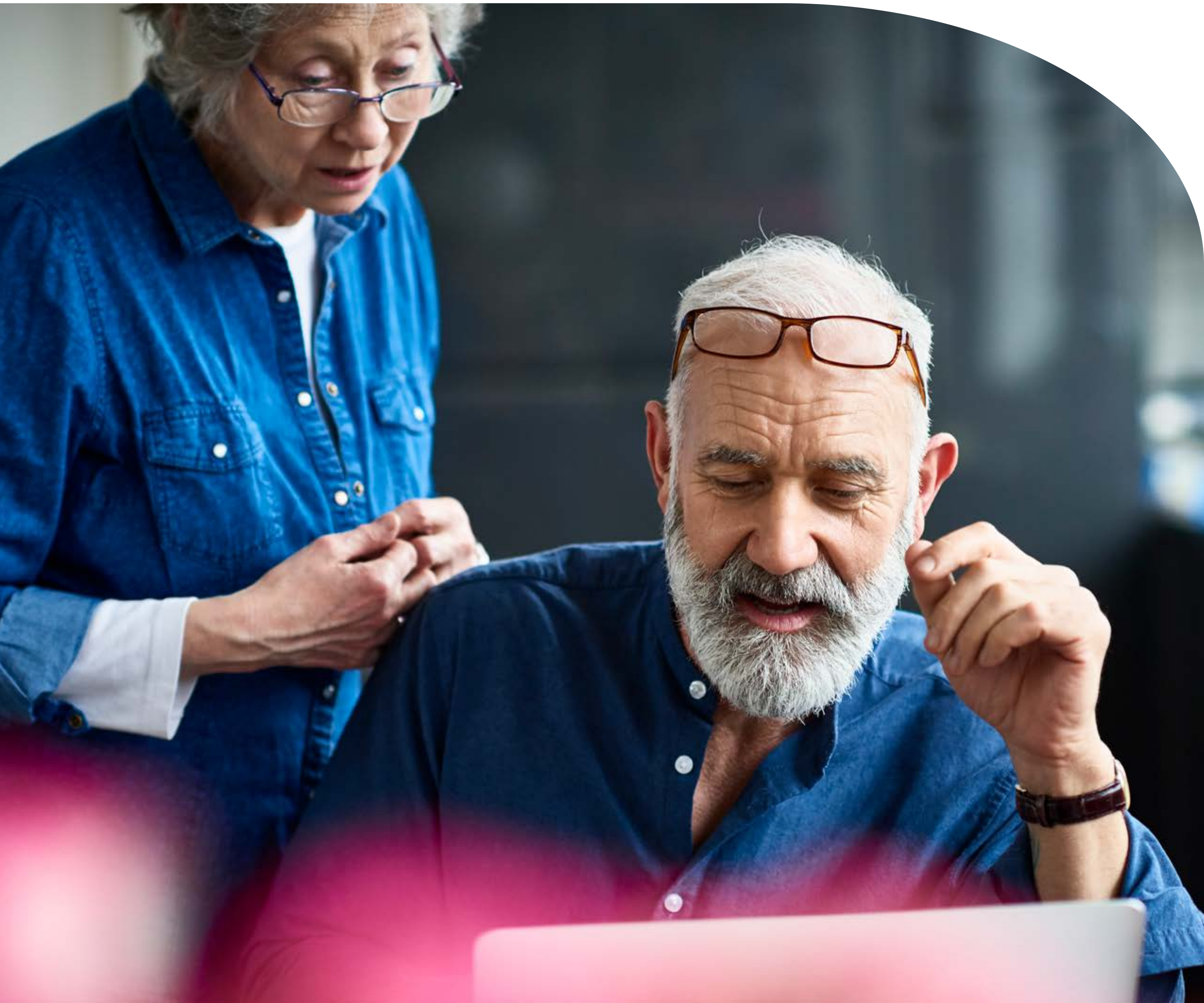
Exiting your business: A guide to valuation



Alongside the decision to start a business, the decision to exit is among the most consequential that ownership and management will ever make. Whether through a sale, merger, or divestment, including a transition of the ownership of a business to family members, an exit demands careful consideration from decision makers so that the final form of the deal satisfies the needs of key stakeholders. To do so, stakeholders must ensure that they have a solid grasp of each component of the process from preparing the company to be sold to its valuation to pricing negotiations.

This guide, the second in our series on 'Exiting your business', will help key stakeholders understand the valuation process, including different methods for assessing value, the elements of your business a valuator will examine, and what information influences a valuation.

While the context of this guide is exiting a business, the information provided also applies to valuations conducted for other reasons, including strategic planning, corporate restructuring, and financing.

To assign a reasonable value to your business, you need to understand what the market values in a business and how the realities of your operation translate into a specific assigned value. At its core, valuation is point in time specific and largely a function of prospective discretionary cash flow. The process of a valuation is undertaken to narrow in on what a business' prospective discretionary cash flow can reasonably assumed to be. It's important to note that any valuation is highly contingent on the specific circumstances of your business, your industry and the general business environment, and the needs of potential buyers.

Any valuation is highly contingent on the specific circumstances of your business.

The valuation process

In preparing a valuation report, the following high-level steps should be performed:

- Determine the purpose of the valuation and the applicable type of report to prepare.
- Gather and analyze historical and forecast financial information and discuss with management and other key professional advisors.
- Utilize appropriate valuation approach and methodologies and perform appropriate level of calculation to support a valuation conclusion.
- Present a report that includes an explanation of the selected valuation approach and the reasons for the conclusions.

Each of the steps listed above is reflected in the sections that follow.

Price vs. fair market value

Before digging into the valuation process, it's important to note that there is a difference between the fair market value that will be assessed as part of the valuation and the price that can be secured as part of the selling process.

The valuation delivered in the final report should be performed according to the Chartered Business Valuators (CBV) Institute's definition of fair market value:

"...the highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

Fair market value, as defined above, may or may not equal the purchase or sale price in an actual open market transaction. In the open market, there may exist special-interest or strategic purchasers willing to pay a price in excess of fair market value because they believe they can enjoy post-acquisition synergies, economies of scale, or strategic advantages by combining the acquired business interest with their own operations. Such synergies, economies of scale, and strategic advantages are referred to as *net economic value added*. Thus, for those looking to set a price before going to market, the valuation should be used as a starting point for further analysis that could include identifying potential buyers and the net economic value they'd receive from a purchase of your operations.

A breakdown of the components of value as it relates to an intrinsic value vs. price, is outlined in the graphic below.

Components of value

Step 1: Determine purpose and applicable report

A valuation is telling potential buyers the story of your business. Is your business a reliable revenue source in a stable industry? Or is it a riskier proposition with significant growth potential? Knowing what your business' story is will help you understand where its value originates and how to position it to find the right buyer at the right price.

With a valuation report in hand, you can determine how to best edit your business story. Internally, you can use the report to make adjustments to your business that will enhance its value prior to going to market. A valuation report will help identify areas that will be seen as potential weaknesses by an outside party, which is a reason to routinely conduct a valuation review and adjust your business practices based on its results and underlying conclusions.

Once you know the story your business is telling, you'll know what type of buyer is right for you. Some buyers want steady and reliable cash flows, while others are looking for a potential unicorn—knowing who you are will match you with the right partner. Once you've found the right buyer, you'll then be able to use the valuation as a starting point for negotiation; you'll have a strong financial case to justify your position and begin from a position of strength.

Preparing your business for sale

- [x] Separate personal goodwill from commercial goodwill
- [x] Remove redundant assets from the company (cash out)
- [x] Optimize tax planning measures ahead of a transaction
- [x] Enter into or extend existing contracts with key customers and suppliers
- [x] Reduce economic reliance on customers and suppliers
- [x] Margin maximization
- [x] Establish and lock in a good management team
- [x] Settle all litigation and environment matters
- [x] Improve operating efficiencies
- [x] Clean up the financial statements (uncollectible accounts receivable , slow-moving inventory)
- [x] Demonstrate growth by creating and achieving budgets
- [x] Eliminate discretionary non-business expenses
- [x] Stop cash business well before the sale
- [x] Sell at the peak of a business cycle or after you have proven successful cash flows and earnings.

Report type

The level of detail and analysis is predicated on the level of valuation report being prepared. A formal valuation report conducted by a CBV can be categorized into three types, each of which contains different amounts of analysis and assurance.

Calculation report

This is a high-level report that will contain a conclusion as to the value of shares, assets or an interest in a business based on a minimal review and analysis and little or no corroboration of relevant information and will be generally set out in a brief document.

Estimate report

This type of report will contain a conclusion as to the value of shares, assets, or an interest in a business based on a limited review with some additional analysis and corroboration of relevant information and will be generally set out in a less detailed valuation report.

Comprehensive report

This type of report will contain a conclusion as to the value of shares, assets, or an interest in a business based on a comprehensive review and analysis of the business, its industry and other relevant factors. It will include adequate corroboration and will be generally set out in a detailed valuation report.

Selecting which type of valuation report to undertake will be driven by its ultimate purpose. While a comprehensive report incurs a greater cost and requires more time and resources to compile, it will also provide the highest level of analysis, which can lead to deeper insights as to how to adjust your business and increase its value. As a result, management should weigh the investment in its the valuation report against the needs of its key stakeholders when deciding which level of valuation to pursue.

It should be noted that a valuator will provide no opinion, attestation, or other form of assurance with respect to the valuation or the information upon which the valuation is based. Nothing contained in a valuation report constitutes an audit or review of future oriented financial information, in accordance with the standards of the Chartered Professional Accountants of Canada. A valuator will not audit, review, or otherwise verify the information provided to in the context of the engagement.

It's always strongly advised that third parties, potential investors, lenders and others seek out independent corporate finance, accounting, and income tax advice separate from a valuation analysis/report.

Step 2: Gather and analyze data and hold discussions with management

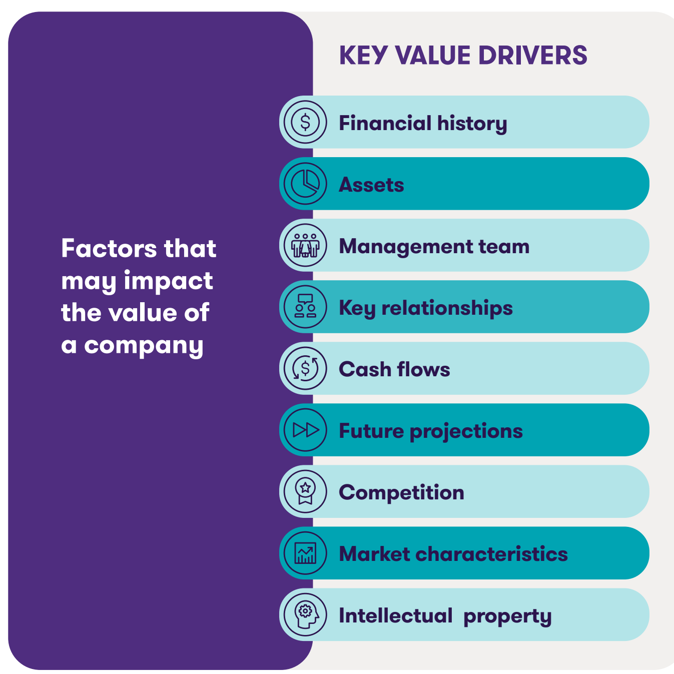
Whatever the level of detail you select, the process of conducting the valuation will begin with the gathering of historical and forecasted financial information, and an analysis of the company's operating and financial results covering five fiscal years leading up to the date at which the valuation is executed (the valuation date).

To analyze historical and prospective revenue, gross margin, and expenses, a valuator will make adjustments to reflect the business' actual performance and financial position by accounting for:

- Irregularities that may or may not occur beyond the valuation date.
  - Non-recurring example: If the company incurred significant one-time legal fees relating to a corporate restructuring in a given year, these would be removed in the determination of the normalized level of expenses to operate the business as these are non-recurring in nature.
- Revenue or expenses that may not reflect market rates.
  - Market-rate adjustment example: The company may be leasing a property from a non-arm's length party at a rate above or below market rates. An adjustment would be made to the annual rent expense to reflect market rates if operating at arm's length.

These are referred to as 'normalization adjustments' and are intended to adjust the company's historical and forecasted performance as if it operates under market participant assumptions (i.e., at market rates).

At a high level, value will be assessed based on the factors below.



Value drivers and considerations

As part of gathering and analysis, the valuator will want to discuss key financial information with management and other key professional advisors to augment their knowledge of the business, and to obtain explanations and clarifications of the data provided. Below is a set of sample questions that may be asked during the valuation process.

Financial history

- What have our revenues/profits been over the past five years?
- What are some of the factors that have contributed to the growth (or decline) in revenue and expenses over the historical period? Are these expected to continue moving forward?
- Has there been any non-recurring income or expense items recorded in financial statements in the last five years?
- Are expenses that are charged to the operations, including related party transactions, at market rates?
- How much debt do we carry?

Assets

- What are our core fixed assets?
- What levels of inventory do we maintain?
- Are there any assets deemed to be redundant to the continued operations of the company? Redundant assets may include such things as excess cash, short or long-term investments in public securities, loans receivable, or physical assets that are not used in the business (e.g., unused space in the factory, under-utilized equipment).
- What real estate deeds, leases and mortgages do we hold, if any?

Management team

- Who are our key people and what are their backgrounds/specialties?
- How long have they been with the company?
- Are customer relationships heavily tied to the management team?
- Will they be included in any deal?

Key relationships

- Who are our key clients and what percentage of our revenues are driven by them?
- Who are our key vendors and what long-term agreements/contracts do we have with them?

Cash flows

- What are the annual capital expenditure requirements?
- What is a typical working capital level of the company?

Future projections

- Are forecasts/budgets prepared on a regular basis?
- Do we anticipate future growth?
- What are the growth drivers/key assumptions we're using to make these projections?

Market characteristics

- Have there been any sales/mergers/IPOs of similar companies in our industry recently?
- Is our industry growing or mature?
- Are current market conditions favourable or would waiting to sell be prudent for shareholders?

Competition

- Who are our key competitors?
- What is our industry position relative to our competitors?
- How does our financial performance and key reporting benchmarks match up against our competitors?
- What are the strengths, weaknesses, opportunities, and threats tied to the business and how do we compare to the market?

Intellectual property

- What patents, copyrights, trademarks, and trade secrets do we hold?
- What is our company's intellectual property?

Step 3: Select valuation approach and assess risk

Selecting the right methodology will depend on the specific circumstances and nature of your business, including business type, industry standards and trends, availability of reliable financial information, and the size and maturity of your business. You may also want to analyze your business using multiple methodologies to give you a better understanding of how a potential buyer may assess your business' value.

The following is an overview of the various types of valuation approaches that can be used in the valuation conclusion.

Asset-based

An asset-based valuation approach will explore the market value of the total assets (less liabilities) of an entity and may be used under either a going concern premise (i.e., an enterprise is viable as a going concern but has no commercial goodwill) or a liquidation premise (i.e., an enterprise is not viable as a going concern, or the going concern value approximates the liquidation value).

There are two commonly used types of asset-based valuations:

Adjusted book value

The adjusted book value method may be appropriate to use when net realizable value, as opposed to cash flow, constitutes the prime determinant of fair market value for a business. This method focuses on individual asset and liability values from the company's balance sheet, which are adjusted to fair market value.

Liquidation value

The liquidation value method measures the amount of cash available to shareholders assuming the business is discontinued, the underlying assets are sold, and all related costs of disposition and income taxes, as well as outstanding liabilities, are paid. In a going concern business, liquidation value is principally used as a measure of downside risk associated with operations (i.e., the amount of shareholder investment that is theoretically "not at risk").

ASSET-BASED VALUATIONS

Pros

- Backed by hard numbers on the balance sheet
- Everything laid out clearly in financial statements, which makes it easier to agree on the state of the business
- General practices are widely known so investors/buyers will have confidence in the valuation

Cons

- Overlooks future earning potential
- Undervalues intangibles

Works best for

- Real estate, established industrial properties
- Holding companies that derive value from underlying assets, rather than earnings
- Companies whose ability to continue operating as a going concern is uncertain or whose returns based on earnings or cash-flows are insufficient to provide an adequate return on invested capital

Earnings-based

An earnings-based valuation establishes a company's value based on its ability to generate profit and cash flows over time. This approach may be appropriate for cases in which a business' future earnings are likely to support a value in excess of the value of net assets employed in its operations.

There are two commonly used types of earnings-based valuations:

Capitalized cash flow

Under the capitalized cash flow (CCF) methodology, an estimate is made of the maintainable earnings before interest, taxes, depreciation, and amortization (EBITDA) based on historical and prospective operating results. Income tax, working capital requirements, and sustaining capital expenditure requirements are then deducted to determine the maintainable discretionary after-tax cash flow. The maintainable discretionary cash flow is then divided by a rate of return which reflects the risks in generating the adopted level of maintainable discretionary cash flow on a prospective basis, resulting in the capitalized cash flow.

This approach is typically adopted when prospective earnings are expected to be constant or grow at a uniform rate over the long term.

Discounted cash flow

The discounted cash flow (DCF) methodology involves forecasting the annual discretionary cash flow to be generated by the company for a period of time and discounting those projected discretionary cash flows at a rate of return that reflects the risks of achieving the same. An estimate is then made of the value of the discretionary cash flows beyond the discrete forecast period, which is referred to as the terminal value. The terminal value is determined by applying a capitalization rate to the expected annual discretionary cash flows to be generated beyond the discrete forecast period. The sum of the present value of the discretionary cash flows for the discrete forecast period plus the present value of the terminal value cash flows represents the net present value of the forecast cash flows of the company.

This approach is typically adopted when prospective earnings are expected to grow at a non-linear rate over the long term.

EARNINGS-BASED VALUATIONS

Pros

- Directly ties value to objective results as indicated in financial statements
- Projections allow you to capture anticipated growth as part of the valuation

Cons

- Changes to inputs will have a significant impact on valuation so a bad quarter or year can severely impact the outcome
- Requires the development of a financial forecast, which may not be readily available from management

Works best for

- Companies with cash flow and profits that may not align with historical performance, including companies such as those in a hyper-growth stage or in the early stages of its life cycle
- Companies that have visibility into future performance and results

Multiple of earnings/ market-based

A market-based valuation approach may be appropriate where meaningful financial information is available for companies or transactions that are considered comparable to the subject business. Care is required in assessing the degree of comparability of such companies or transactions, which often limits the usefulness of market-based approaches in valuing privately owned companies.

Market-based valuation methods include comparisons of the subject business' financial results to the results and stock prices of 'comparable' public companies (the guideline public company method); or comparisons of the valuation ratios achieved in precedent transactions to the corresponding metrics of the subject business (the guideline transaction method).

MARKET-BASED VALUATIONS

Pros

- Valuation conclusions are benchmarked to valuation metrics/multiples to other similar companies
- Applies actual trading multiples within the market to the company being valued

Cons

- It can be difficult to find direct comparables within the public market due to differences in the size, customer base, geographic location, as well as other operating features compared to the company being valued
- Public information regarding comparable transactions may be limited

Works best for

- A secondary valuation approach whereby the primary valuation approach, such as a CCF or DCF, is compared to the market-based multiples to assess reasonableness

Valuation approach triangulation

Generally, valuation reports are conducted using a combination of valuation approaches outlined above to arrive at a triangulation of value in which all relevant approaches will be considered and assessed for reasonableness.

Rates of return (multiples)

The rate of return (also known as the discount rate or weighted average cost of capital) of a business is a key driver of the valuation of a company. The discount rate is influenced by multiple factors both on a qualitative and quantitative basis. The rate of return is a function of risk factors and opportunities of the company including, but not limited to, the following:

- Revenue stability
- Revenue concentration with key customers
- Dependence on key employees
- Growth potential
- Industry and economic trends
- Company size–higher rates of return for small companies, start-ups and high-risk businesses

The after-tax rate of return is applied to the after-tax cash flows of the business and is an inverse of the implied valuation multiple (i.e., a low rate of return implies a lower risk profile of the company and a higher implied valuation multiple).

Steps 4: Present draft report followed by final report with conclusion of value

Once the information is gathered and analyzed, it will be presented in the form of a draft report that assigns a value and details the methodology and choices used to reach the conclusion. If the process above has been followed, it should clearly demonstrate how the value was determined. However, there are usually points of clarifications, updates to key inputs, and other adjustments that will need to be made to deliver the final report. As a result, a valuation report is initially provided in draft form to allow management to review all inputs and assumptions prior to the finalization.

Conclusion of value

The value conclusion can be broken down into the following components:

- Tangible operating assets, net of liabilities
- Identifiable intangible assets and goodwill

Tangible operating assets are the resources directly used to maintain operations and generate revenue for the business. This can include fixed assets such as land and machinery, and cash assets like inventory and accounts receivable. Identifiable intangible assets don't directly maintain operations but can be separated from other assets, assigned their own value, and sold. This can include customer relationships, patents, brands, and operational know-how.

In contrast to identifiable intangible assets, goodwill cannot be directly quantified and must be calculated as a residual value in the purchase price equation. This is done by taking the enterprise value (EV) of the company and subtracting its tangible asset backing (TAB). The TAB of a business is the value of the operating assets (e.g., tangible assets and specifically identifiable and quantifiable intangible assets) less operating liabilities (not debt), and is contemplated assuming the business continues as a going concern.

Next steps

Undertaking a valuation is an essential part of exiting your business—and of planning in general—but to get the most out of it you'll need to identify how you can *increase* your value before going to market. That requires additional strategic planning, operational improvements, and an understanding of what potential buyers will be looking for. It's a complex process, but Doane Grant Thornton can help—contact your local advisor or reach out to us here. You can also follow along with our series of guides on exiting your business. Our next guide will focus on finding a buyer.

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