What is Your Business Worth?

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– Have your badge scanned in and out at the door  
– Attend 90% of this presentation  
– Fill out the online evaluation for this session
Reasons for Valuation

- Gift, estate and income tax planning
- Advisability of public stock offerings
- ESOP transactions
- Buy-sell agreement transactions
- Divorce proceedings
- Internal sales to employees or family
- Merger / acquisition / divestiture transaction
- Valuing your strategic or business plan
- Personal financial planning

Approaches to Valuation

- Market approach
  - Internal stock sales
  - Comparable private transactions
  - Public company comparison

- Asset-based approach
  - Book value
  - Net asset value
  - Liquidation value

- Earnings-based approach
  - Price to historical earnings (P/E) multiple
  - Discounted future earnings
Market Approach

- **Internal Stock Sales**
  - Independent appraisal
  - Arm's length
  - Unique circumstances

- **Comparable Transactions**
  - Data not available
  - Limited number of events

- **Public Company Comparisons**
  - Price to earnings, cash flow, revenue, book value
  - Similar public company
  - Data available
  - Accepted by IRS
  - Minority interest
  - Liquidity issues

Asset-Based Approach

- Book Value
- Adjusted Book Value
- Liquidation Value
Book Value

**Definition:**
assets minus liabilities

**Interchangeable with net worth or shareholders' equity**

**Major benefit ... easy to identify and understand**

### Valuations Based on Book Value

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets:</strong></td>
<td><strong>Current Liabilities:</strong></td>
</tr>
<tr>
<td>Cash and Equivalents</td>
<td>Accounts Payable</td>
</tr>
<tr>
<td>$290,000</td>
<td>$948,000</td>
</tr>
<tr>
<td>Accounts</td>
<td>Accounts Payable</td>
</tr>
<tr>
<td>$2,150,000</td>
<td>Short-Term Notes Payable</td>
</tr>
<tr>
<td>Receivable Cost in excess of Billings</td>
<td>Current Long-Term Debt</td>
</tr>
<tr>
<td>$647,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>Other Current Assets</td>
<td>Other Current Liabilities</td>
</tr>
<tr>
<td>$208,000</td>
<td>$151,000</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td><strong>Total Current Liabilities</strong></td>
</tr>
<tr>
<td>$3,295,000</td>
<td>$1,672,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Furniture, Fixtures and Equipment-Net</strong></th>
<th><strong>Long-Term Debt</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>$585,000</td>
<td>$427,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Real Estate and Leasehold Improvements - Net</strong></th>
<th><strong>Accrued Taxes</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>$375,000</td>
<td>$170,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Other Assets</strong></th>
<th><strong>Other Liabilities</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>$145,000</td>
<td>$131,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Total Non-Current Assets</strong></th>
<th><strong>Total Non-Current Liabilities</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,105,000</td>
<td>$728,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Total Assets</strong></th>
<th><strong>Total Liabilities and Equity</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,400,000</td>
<td>$4,400,000</td>
</tr>
</tbody>
</table>

**Total Liabilities** $2,400,000

**Equity** $2,000,000
Problems with Book Value

- Book value does not reflect …
  - Earning power
  - Quality of backlog or accounts receivable
  - Market trends / competitive situation
  - Management quality / depth / age
  - Market value of the firm’s assets
  - “Hidden” assets
  - Excess (or inadequate) compensation and fringe benefits to the owner(s)
  - Dividends paid or non-operating assets
  - Working capital expenditures needed to keep the firm profitable or for growth
  - Any contingent liabilities

Adjusted Book Value

- Book value adjusted to reflect the market value of assets and liabilities
- Also commonly referred to as “net asset value”
- Estimate of investment required for start-up
- Used in most asset transactions
Liquidation Value

- **Definition**: adjusted book value minus costs of liquidation
- Orderly versus fire sale
- Establishes minimum for seller
- Buyer’s downside protection
- Assumes termination of the business

Liquidation Costs

- Appraisal and real estate commissions
- Expenses or discounts associated with liquidating furniture, fixtures and equipment
- Cost of cleaning up assets for sale
- Slow pay of accounts receivables when liquidating
- Erosion of profit in the work-in-process due to
  - Key people leaving for new jobs
  - Subcontractors and suppliers becoming non-responsive
- Overhead continuing during the wind-down process
Liquidation Costs

- Legal and accounting fees
- Taxes
- If the backlog can be subcontracted to another firm, a significant discount on the face amount of the backlog could be expected
- Total liquidation costs could range from 20% to 70% of adjusted book value

What Drives Value?

\[
\text{Value} = \text{CM} \times \text{E}
\]

\textit{Earnings}

(Capitalization Multiple)
Factors Creating Salability & Value (1 of 2)

- Profits
  - Size and growth
  - Volatility
  - Recurring
- Type of customers, services and markets
  - Strategic appeal to potential buyers
  - Service component
  - Negotiated/less price sensitive
  - Recurring client opportunity

Factors Creating Salability/Value (2 of 2)

- Critical mass
- Management and organization
- Growth potential
- Synergy with buyer
  - Client base
  - Cost structure
- Location
- Scarce resource
  - Real estate
  - Material reserves
  - Permits
  - Technical or operational capability
  - Labor
Earnings-Based Approach

- Value based upon the earning capacity of the company
- Earnings calculations considered
  - Historic
  - Current
  - Projected
- Values based on
  - Multiple of historical earnings (P/E ratio)
  - Discounted future earnings (minimum rate of return)

What Are Earnings?

- Earnings can be categorized as
  - Operating and non-operating
  - Recurring and non-recurring
- Normalized earnings are earnings generated from operations over a period of time adjusted for non-recurring items and discretionary owner-related expenses
Determining Normalized Earnings

- Identify historic reported earnings and expected actual earnings
- Make adjustments to historic earnings to reflect ongoing earnings

Adjusted to Earnings to Determine Normalized Earnings

- Exceptional project losses or earnings / claim settlements
- Excessive or insufficient owner or management salaries, perquisites and benefits
- Boats, cabins, automobiles, club memberships or similar expenses
- Favorable rental rates with related parties
Adjusted to Earnings to Determine Normalized Earnings

New division start-up costs / acquisitions costs / discontinued operations

Dead wood (or relatives) at the labor, supervisory or management levels

Non-operating items (gain or loss on sale of assets or other business segments, income from investments)

Items expensed that should have been capitalized

- Asset purchase
- Training program
- MIS systems installation

Non-recurring items (prior period adjustments, tax-loss carry forward, legal settlements, accounting changes)
Adjusted to Earnings to Determine Normalized Earnings

Extraordinary adjustments
- Insurance recovery
- Investments in companies
- Goodwill
- Excess depreciation

Off-balance-sheet obligations and assets
- Leases
- Deferred compensation agreements

Determining Earnings Capacity or Sustainable Earnings

Long-Term Historical Average
Determining Earnings Capacity or Sustainable Earnings

Near-Term Historical Average

Determining Earnings Capacity or Sustainable Earnings

Upward Forward Projection
Determining Earnings Capacity or Sustainable Earnings

Downward Forward Projection

Capitalizing Measures of Earnings

- **Multiple of Pre-Tax Earnings**
  - Determines the value of stock or equity
  - Typically used for general building contractors
    - Generally little or no debt
    - Captures ability to generate earnings through management of the balance sheet

- **Multiple of EBIT (Earnings Before Interest and Taxes)**
  - Determines Value of Invested Capital
    - *(i.e. Equity + Debt – Cash)*
  - Typically used for most contractors
Capitalizing Measures of Earnings

- **Multiple of EBITDA**
  - Determines value of invested capital
  - Generally considered a cleaner measure of earnings
  - Typically used for contractors with a physical plant

What Drives Value?

\[
\text{Value} = \text{CM} \times \text{E} \\
\text{(Capitalization Multiple)}
\]

- Sustainable Operating Earnings
- +/- Adjustments
- Risk & Salability
- Growth (in earnings)
Price to Earnings Ratio (P/E)

- Equals the current price of the stock divided by 12 months of earnings
- P/E ratio for privately held contractors range from three to four times normalized pretax earnings
- Adjust the closely held firm P/E based on the following similarities or differences to publicly traded companies

Public Versus Private P/E Ratios

- Control the ability to ...
  - Appoint board of directors
  - Declare dividends
  - Hire, fire and set compensation
  - Force merger, sale or liquidation
  - Other major management and financial decisions

- Size
- Diversification of business activities
  - Geographical
  - Product
- Management depth
- Future earnings prospects
- Financial condition
- Access to capital markets
- Marketability
Earnings Growth

- Market niche
- Market demographics
- Mix of new construction, reconstruction, service and maintenance work
- Ability to establish branch offices or successfully acquire other firms
- Ability to attract and develop people

Earnings Quality Analysis

- Management quality and depth
- Self-perform—higher risk, but more control
- Historic volatility of earnings
- Participation in attractive market niches
- Earnings from repeat customers
- Consistency of project budget-to-actual results
- Degree of negotiated versus bid
- Dependency on a few owners
Earnings Quality Analysis

- Consistency of bid results
- Liquidated damages / litigation and claims experience
- Trends in margin
- Reliability of cost-to-complete projections
- Growth opportunity in existing markets
- Unique technical competence

Valuation Trends

- Prior to late 1990's
  - Asset-based and “earn outs” with small premium
- Late 1990's
  - Multiples of EBIT, EBITDA
- 2000's
  - Back to basics
  - Most firms are worth the assets only
  - A strong and consistent profit history might get a “premium”
  - Ninety-five percent of internal deals are at or around book value
  - Private equity wildcard
Exercise – Value the Business

- Do you think your business is worth more than book value?
  - Why?

- Do you have a price target in mind?
  - For a third party sale?
  - For family or employee?

About FMI

FMI is a leading provider of management consulting, investment banking† and people development to the engineering and construction industry. We work in all segments of the industry providing clients with value-added business solutions, including:

- Strategic Advisory
- Market Research and Business Development
- Leadership and Talent Development
- Project and Process Improvement
- Mergers, Acquisitions and Financial Consulting†
- Risk Management Consulting
- Compensation Benchmarking and Consulting

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Questions

Up Next: Interactive Break in the Mezzanine

– Taking Your Company’s Safety Training to the Next Level: Augmented Reality

– It is Not How Much Money You Get, but How Much Money You Keep

– Verizon M2M-Wireless Hub

– How to navigate necanet.org

– Profile of the Electrical Contractor