Succession planning – Business Valuations

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In association with:

Succession planning – Business Valuations

Agenda

1. Do you need a 3rd party valuation?
2. Financial history – relevance / limitations
3. Understanding value and valuation methods
4. Lifetime capital gains exemption
5. Partial sales / Minority shareholders / partners

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1. **Do you need a 3rd party valuation?**

Valuation reports may be prepared for:

- **Business purchases and sales**
- **Succession plans (usually involving family or employees)**
- **Reorganisations (usually tax driven)**
- **Disputes (shareholder, marital)**
- **Public company reporting**

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1. **Do you need a 3rd party valuation?**

Questions you should be asking -

- **How will you determine the value of your business?**
- **Who might challenge that value?**
- **What are the stakes?**

Your answers to these questions will determine if you need a 3rd party valuation and the type of report you need (some valuation reports are more detailed than others).

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2. Financial history - relevance

Financial history supports your credibility.

In planning to sell your business ensure your financial statements are:

- **Sufficiently detailed to tell your story**
- **Truthful and credible**
- **Relevant and useful – a valuator or buyer needs 3 years minimum, 5 years better**

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2. <u>Financial history - limitations</u>

Financial history supports your projections

BUT

- **Value is <u>forward looking</u>**
- **Projected future earnings / cash flows should be "normalised" to reflect the real benefit to a new owner in the bottom line**
- **Expenses should include owners' wages at a market related level**
- **The valuator should make the projections in an objective manner**

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3. Understanding value

Get informed - know *and understand* **your Fair Market Value (FMV) early in the planning stage.**

Recognise that FMV does not = price

- **FMV is objective, fair, notional and the same in all circumstances**
- **Price is largely about negotiation. It may not be fair to everyone**

FMV is good to know before starting to negotiate price (similar to an appraisal on a house). Understanding the components of FMV will help you negotiate.

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3. Understanding value

“Fair market value” assumes a “fair” market:

- Open to a wide range of buyers
- Assets put to their best use
- No-one is being compelled to act
- Informed and prudent parties
- Determined objectively (at “arm’s length”)
- Expressed as a single lump sum settlement

These attributes may not exist in a sale negotiation.

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3. Understanding value

$$\text{Value} = \frac{\text{Opportunity}}{\text{Risk}}$$

- Opportunity = future prospects
- Risk = how certain is future revenue and cashflow?

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3. Understanding value – valuation methods

- Cost (or adjusted net asset)
- Income
- Market

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3. Understanding value – valuation methods

Cost method

- Adjusts assets to be transferred to fair market value and deducts liabilities that will transfer
- Does not normally calculate goodwill or other intangible value (because there is none)
- Typically used for holding companies or when the value in the business is mostly in real estate or high value assets or when the business is under-performing

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3. Understanding value – valuation methods

Cost method - example

Assets at net book value	5,000,000
FMV adjustment	2,000,000
Assets at fair market value	7,000,000
Less liabilities (usually FMV)	(4,000,000)
FMV of the business	3,000,000

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3. Understanding value – valuation methods

Income method

- Capitalizes net cash flow or net income or EBITDA* using a capitalization rate suitable to the risk
- Calculates Goodwill by deducting net tangible assets from capitalized cash flow
- Assumes a normal level of assets and liabilities – may need to be adjusted for "redundant" assets (next slide)
- Typically used for operating businesses generating good returns for the owners

* EBITDA = earnings before interest, tax, dpn

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3. Understanding value – redundant assets

"Redundant" assets are assets in the business not essential to the generation of revenue or profit

- E.g. - excess cash / excess working capital / advances to related parties
- May include unused borrowing capacity
- Real estate sometimes treated as redundant (with adjustment for rent)
- May disqualify owner for lifetime capital gains exemption if too high
- Provide opportunities to pull value out before a sale and thus reduce sale price to a more affordable level for a buyer

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3. Understanding value – valuation methods

Income method – simple example

Maintainable free cash flow	2,000,000
Weighted ave cost of capital	÷ 20%
Capitalized free cash flow	10,000,000
Add: Redundant assets	2,000,000
	12,000,000
Deduct: long term debt	(5,000,000)
Shareholders’ equity	7,000,000
Preferred shares at redemption amt.	(2,000,000)
Common shares at fair market value	5,000,000

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3. Understanding value – valuation methods

Income method – simple example (cont.)

Calculation of goodwill

Capitalized free cash flow	10,000,000
Tangible (operational) assets (FMV)	(7,000,000)
Goodwill	3,000,000

Questions to ask about goodwill

- **Is it reasonable and explainable?**
- **How much is transferable to a new owner?**

Poor transfer of goodwill is a major reason for the failure of some business transitions

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3. Understanding value – valuation methods

Market method

- Uses multiples (applied to Revenue, Gross Profit, EBITDA, Owner's earnings etc.) informed by actual reported transactions involving similar businesses
- Typically used as a primary valuation method only for "cookie-cutter" businesses
- May be useful as a reasonableness test in more complex businesses
- BUT – it is often difficult to find truly comparable businesses and the multiples for those businesses can vary widely

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3. Understanding value – valuation methods

Market method – simple example

EBITDA	3,000,000
Median multiple (for comparables)	X 2.5
Value of the business to be sold	7,500,000
Less liabilities not transferable*	(2,000,000)
FMV of the company	5,500,000

* Extreme care is needed in applying market comparable multiples. Multiples often assume that only the business assets will transfer.

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3. Understanding value – valuation methods

All methods

Whatever the valuation method, some "reasonableness" testing is essential.

E.g.

- **What is the payback period?**
- **What is the payback period for goodwill?**

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3. Understanding value – some common errors

- Assuming that one size fits all (all businesses have different risk profiles, thus should have different cap rates or multiples)
- Cap rates or multiples that are inconsistent with the cash flows to which they're applied
- Incomplete "normalisation"
- Inadequate analysis of supporting assets
- Under-estimating personal (non-transferable) goodwill (can the business run without you?)
- Owners underestimate the risks to an outsider
- Underestimating time to clean up ("purify") – if selling shares, consult your accountant at least 25 months before you want to sell

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4. **Lifetime capital gains exemption**

- Currently shields approx. $824,000 of pre-tax gain
- Available to reduce the tax payable on capital gain on the sale of shares of a "qualified small business corporation"
- Most small companies in Canada should qualify but may be disqualified based on excessive non-business assets
- Some requirements for length of ownership
- Ask your accountant!

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5. <u>Partial sales</u>

(resulting in minority shareholders / partners)

- Partnership or shareholder agreements should be considered MANDATORY (in my opinion)
- Agreements should include a mechanism for valuing shares in the future if there is a disagreement or events requiring a buyout
- Agreements should also deal with the possibility of the majority owner wanting to sell – "tag along", "drag along" clauses
- A good lawyer will include all essential terms - the legal fees are usually worth it
- Minority interests are valued case-by-case

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Objective **Insightful** **Articulate**

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