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Things to do and know - a CBV's perspective

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Agenda

1. **Circumstances benefitting from a 3rd party valuation**
2. **Financial history – relevance / limitations**
3. **Understanding value**
4. **Lifetime capital gains exemption**
5. **Partial sales / Minority shareholders / partners**

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1. <u>Circumstances benefitting from a valuation</u>

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

In considering the need for a valuation, think about who may challenge it and what the stakes are. This influences the type of report needed and the likely fees.

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

Financial history supports your credibility. Ensure it is:

- **Sufficiently detailed (consider review engagements)**
- **Truthful**
- **Relevant / useful – 3 years min, 5 years better**
- **Put your accountant to work!**

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

Financial history supports your projections BUT

- **Value is forward looking**
- **Projections should be consistent with history**
- **Major changes should be factored in**
- **Earnings / cash flows should be "normalised" (may increase calculated value)**

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3. Understanding value

Get informed - know your fair market value (FMV) early

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

FMV is a good starting point in developing price

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3. <u>Understanding value</u>

FMV assumes a "fair" market:

- **Open to a wide range of buyers**
- **No compulsion to act**
- **Informed and prudent parties**
- **Arm's length negotiations**
- **Expressed as a 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?
- Preparing to sell? Increase sales etc. BUT work on the risks as well

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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

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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

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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

- Excess cash / working capital / related parties
- Includes unused borrowing capacity
- Real estate sometimes treated as redundant (with adjustment for rent)
- May disqualify for lifetime capital gains exemption
- Provide opportunities to pull value out and reduce "unaffordable" sale price

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3. Understanding value – valuation methods

Income method – example (simplified)

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 – example (simplified, continued)

Calculation of goodwill

Capitalized free cash flow	10,000,000
Tangible assets backing at FMV*	(7,000,000)
Goodwill	3,000,000

How much is transferable? / Personal to owner?

* Tangible assets backing = assets used in the business, net of short term liabilities

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3. <u>Understanding value – valuation methods</u>

<u>Market method</u>

- Uses metrics (applied to Revenue, Gross Profit, EBITDA, Owner's earnings etc.) informed by transactions in the market involving similar businesses
- Difficult to find truly comparable businesses
- Can be useful as a reasonableness test

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3. Understanding value – valuation methods

Market method - example

Earnings before interest tax dpn.	3,000,000
Median multiple (for comparables)	2.5
Value of the business	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

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3. <u>Understanding value – common errors</u>

- One size fits all (all businesses have different risk profiles, thus different cap rates or multiples)
- Capitalisation rates inconsistent with cash flows
- 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") pre-sale

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4. **<u>Lifetime capital gains exemption</u>**

- 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 / Minority shareholders / partners</u>

- "Good fences make good neighbours"
- Partnership agreements / Shareholder agreements should be considered MANDATORY (imho)
- Agreements should include a mechanism for valuing shares if there is a disagreement leading to a buyout
- Agreements should also deal with the possibility of the majority owner wanting to sell – "tag along", "drag along" clauses
- The value of non-controlling interests is case specific

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