8 values drivers of your business

GATEWAY
BUSINESS BROKERS

Thank you for your interest!

Sale price is determined by the marketplace, the intrinsic worth of your business (including value drivers specific to your business) and the skill of your transaction advisors. In this ebook, we offer you some important tips and advice on the valuation of your business.

Who we are

Gateway Business Brokers has a singular focus: maximizing business buying and selling opportunities for entrepreneurs in throughout Atlantic Canada and Western Canada. Our success is built on facilitating win/win transactions for the well-qualified buyers and sellers we represent. Our key to success is our proven process designed to deliver outstanding results for both parties in every sales transaction.

We place a priority on maintaining **transparency** in the sale and purchase of every business. We honour our duty to hold every transaction in the **strictest confidence** to protect your privacy and the viability of the sale. Both buyer and seller can expect **loyalty** and full disclosure from Gateway Business Brokers throughout the transaction.

Who we are

Gateway recognizes that buying or selling a business will often be the <u>most significant transaction a family will undertake</u>. Many of the buyers we work with are moving to a new province, stepping into a completely new way of life. For these reasons, Gateway is often required to support both parties to ensure a **successful transition.**

This balanced, advisory approach is for the benefit of both parties, regardless of which side of the table you are seated.

There is no greater success for us than having happy clients.

Marketplace

1

The necessary starting point

An estimate of deal value or the likely sale prices tells you what businesses similar to yours have sold for, but doesn't tell you what your business will sell for, only the likely range of value.

The information is not difficult to obtain, provided one has access to current databases and has recent M&A experience in your industry.

Formula or Typical Methodology

2

The most important component of formulas used to determine a range of value is cash flow

Valuation is typically a multiple of available cash flow. You hear of businesses being sold for a "three multiple of cash flow" or "six times cash flow."

The natural question to ask is, "What is cash flow?"

Depending on how cash flow is defined, one person's value of four times "cash flow" can be far more than another person's valuation of the same company using ten times "cash flow." The first person may use earnings before interest, taxes, depreciation and amortization (EBITDA) while the second refers to net after-tax income.

Consequently, be cautious when someone -- an industry consolidator or perhaps an advisor you hear at a seminar or workshop -- starts tossing around market values based on five times cash flow, etc.

Formula or Typical Methodology

The two most commonly used definitions of cash flow or earnings are "EBIT" and "EBITDA"

- **E.B.I.T**

  Earnings Before Interest and Taxes

  To determine EBIT, take your recast earnings (more about that in a moment) and add any interest expenses and income taxes paid.

- **E.B.I.T.D.A**

  Earnings Before Interest, Taxes, Depreciation and Amortization

  EBITDA is determined by adding back depreciation and amortization as well as taxes and interest to your recast earnings.

Formula or Typical Methodology

When we refer to recast earnings we mean the process of restoring the mountain of pre-tax earnings your business had before you and your CA reduced it to a molehill of taxable income

You did this, in part, by taking a salary and bonus higher than the salary you would pay your replacement. Most owners also receive higher than normal lease payments if the company leases facilities, buildings, or equipment from them. There are a myriad of other tax planning techniques (such as imaginative inventory adjustments) used to adjust income downward.

Recasting income adds back your clever income adjustments to earnings for EBIT and EBITDA purposes.

Formula or Typical Methodology

Just remember not to be *too creative*: buyers are skittish around owners who seemingly skirt the tax law.

This recast cash flow is commonly projected forward using a discounted cash flow analysis (DCF) to arrive at the business value. This is a somewhat complicated but popular method likely to be used by both buyers and sellers. Take a deep breath as you return to Accounting and Finance 201.

Discounted Cash Flow Analysis

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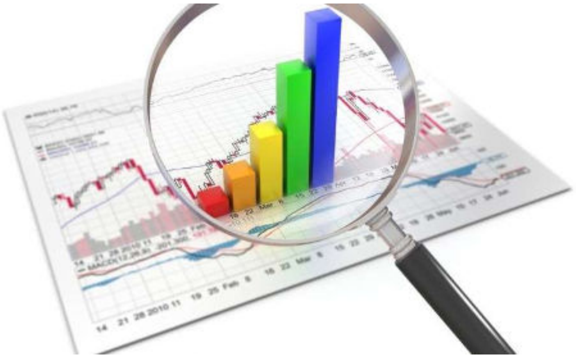
Up to this point, we have determined that the buyer will focus on cash flow, and we have examined the need to properly recast the company's cash flow.

Discounted Cash Flow Analysis



In real world situations, the projection of future cash flow of a business is the most important factor in computing a business's value. In negotiating a sale of a business, both seller and buyer will prepare a projection of future cash flow. The cash flow will then be valued using a discounted cash flow analysis. The negotiation of price will be centered on whose vision of the future is more believable (i.e. how much risk is involved in predicting the future).

Discounted Cash Flow Analysis

The four key steps in preparing a discounted cash flow are:

- Prepare future cash flow projections for one business cycle (generally assumed to be five years).
- Determine the risk-adjusted rate of return expected to be achieved.
- Estimate the value of the business at the end of the projection period (terminal value).
- Apply the discount rate to the projected cash flow including the terminal value (computing the value).

Cash Flow Projections

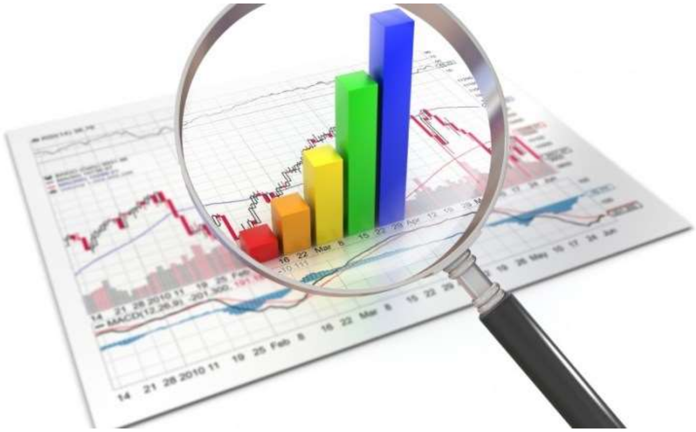
4

Cash flow projections must be based upon sound business judgment and reasonable assumptions

The cash flow projections should take into account the industry cycle, product life-cycles, market trends, capital investment needed, increased working capital requirements and the other factors discussed previously.

Well thought-out and well-prepared projections can increase the buyer's comfort level when evaluating the business.

Cash Flow Projections



The buyer's increased comfort level can enhance the seller's position during negotiations. It is important to realize that no matter how good your projections are, buyers will make their own assumptions and prepare their own projections. Your job, and the job of your investment banker, is to help the buyer to see the significant opportunities your business represents and help the buyer justify using favourable assumptions when preparing his own estimates of future cash flow.

5 Terminal Value

A second component of the future cash flow that your business will generate is called the terminal value.

Basically, terminal value is the amount of money that you, or the buyer would receive in an assumed sale of the business at the end of the period for which the cash flow projections were prepared. The estimate of what the business can be sold for at the end of the projection period is typically determined using either a capitalization of earnings approach.

Terminal Value

The terminal value cash also is determined using a liquidation approach if the business is assumed to have no going concern value at the end of the projection period. Computing the terminal value is important because the value of a business is based on the total future cash flows. Those total future cash flows must include what the business may be worth at the end of the projection period.

In summary, future cash flow is equal to the sum of cash to be received during the projection period plus the value of the business at the end of the projection period.

Determining the Discount Rate

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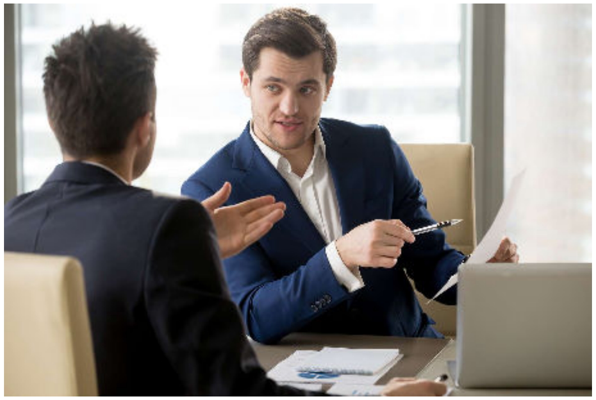
After the future cash flow projections are complete the next step in the discounted cash flow analysis is to determine an appropriate discount rate.



The discount rate factor is used to determine the current value of a stream of income to be received in the future, assuming a minimum acceptable rate of return for the risk being taken. The discount rate takes into account the time value of money, as well as the relative risk that future cash flows may differ from projections.

Determining the Discount Rate

There are numerous ways to determine a discount rate, but sophisticated buyers generally use the after-tax Weighted Average Cost of Capital ("WACC") as the method of determining the minimum acceptable rate of return on an investment.

Basically, WACC is a calculation of the buyer's cost of debt and equity, weighted according to the percentage of each in the buyer's overall capital structure. WACC is determined using the fair market value of the buyer's debt and equity, which, if you are not dealing with a public company, is often difficult to determine.

Determining the Discount Rate

Any good corporate finance textbook will contain a thorough discussion of how to calculate WACC. For those of you who are less inclined to spend your time reading finance textbooks, I suggest that you rely on your investment banker to make this calculation.

Determining the Discount Rate

As a final note, you should know that each buyer will have its own WACC.

Therefore, it is important that you, or your advisors understand each buyer's capital structure, because it will impact the price that the buyer will be willing to pay for your business.

7

Computing the Value

The final step in the discounted cash flow analysis is to apply the discount rate to the projected cash flow and the terminal value.

This last step in the discounted cash flow process is merely a mathematical calculation that any computerized spreadsheet can complete in seconds. By applying the discount rate to the projected cash flow and terminal value cash flow a buyer can determine the maximum price they would be willing to pay today to receive the cash that your business will generate in the future.

Computing the Value

At this point your head may be spinning and you are saying to yourself, "*I knew there was a reason that I didn't major in accounting or finance*."

The concepts and formulas outlined above are generally understood by those of us who specializing in buying and selling businesses. If you are not convinced that your business broker or transaction advisor thoroughly understands cash flow forecasting, DCF and WACC, then you should find another advisor.

Computing the Value

The main thing for you to remember about the discounted cash flow method of valuing a business is that sophisticated buyers (i.e. those with real money) are using this method to determine how much they will pay you for your business.

In summary, the market value of your business will be determined by what a buyer is actually willing to pay. The amount that the buyer is willing to pay will be based upon his perception about the future cash flow that the business will generate for him.

Computing the Value

Your job, and the job of your investment banker, is:

- to communicate to potential buyers the positive opportunity that your business offers;
- to demonstrate how your business fits a buyer's overall strategy; and
- to prove that your business is a cash flow-producing machine.

Computing the Value

Your investment banker has another job:

to bring to the table a number of qualified buyers and to understand what it is about your business that appeals to each buyer.

If your investment banker is able to attract the right buyers and create a market for your company, you should have little doubt about the true market value of your business because you will have real offers to consider.

8 Value Drivers

Last, but certainly not least, each business has its own set of Value Drivers.

Value Drivers are the factors in your business that will lead a buyer to pay more -- or less -- than indicated by industry multiples.

If you hear that companies in your industry sell for five times EBIT and your EBIT is $2 million per year. Is your business worth $10 million? Is it worth more? Is it worth less? Much depends on the intrinsic qualities of your business we call Value Drivers. Value Drivers can be implemented now and used to increase the value of your company.

Value Drivers

There are 7 Value Drivers we look to understand, in preparation of an accurate and engaging Offering Memorandum to position the business for highest value:

1. Current Management structure and performance of workforce.
2. Systems that "sustain" the growth of the business.
3. Customer base – established and diversified.
4. Facility – does it represent the "value" of the business, is their room for growth
5. Growth Strategies – realistic and documented
6. Financial Controls – effective and documented
7. Growth in cash flow, profitability, and revenues

Thank you

902.441.9589

WE WELCOME A CALL ANYTIME

GATEWAY
BUSINESS BROKERS

gatewaybusinessbrokers.ca

P: 902.441.9589
F: 902.576.5683
Toll free: 1.877.314.5683

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