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# VALUE ADDED™

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## Valuation and Business Concentrations

Concentrations are a significant issue in valuing a business enterprise. The presence and magnitude (or absence) of business concentrations are major considerations in assessing a subject company's risk profile and financial outlook. Other things being equal, the presence of significant concentrations frequently results in a lower value than otherwise might be expected because the appraiser considers it necessary to apply a higher discount rate or required return, a lower forecast of future earnings, a lower expected earnings growth rate, and/or a lower capitalization factor (earnings or cash flow multiple) in developing his opinion of value.

***The presence and magnitude (or absence) of business concentrations are major considerations in assessing a subject company's risk profile and financial outlook***

The term "business concentrations" covers a variety of situations, including a company dependent on:

- A single customer or a small group of customers for all or a major portion of its sales
- Customers within narrow industry segment for all or a major portion of its sales
- Sales within a narrowly defined geographic territory
- A single product or service with limited applications for all or a major portion of its sales
- A single supplier for a key production input (materials or equipment)
- A limited pool of workers with highly specialized skills
- Technology and other intellectual properties (trade secrets, patents, copyrights, etc.) controlled by others which an essential element in its services, products, or production processes
- Internal concentrations, such as dependency on a key manager or worker, operation from a single plant, dependence on a single piece of equipment, etc.

*(Continued on Page 2, Column 1)*

## When Down Is Not Necessarily Down

### *A Closer Look at the Recent "Decline" in Acquisition Multiples*

*Acquisition multiples are down substantially compared to historical levels. This most recent negativity is actually part of a longer downward trend that began in the 1998-1999 period. Chart 1 on page 3 outlines the average EBITDA multiple paid in deals announced from 1996 through 2001* (S&P Portfolio Management Data, *M&A Today*, June 2001).

As is typical, acquisitions of smaller companies have been priced at even lower average multiples when compared to the entire group (see Chart 2). During the six months ended March 31,

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Concentrations have two detrimental impacts on the company's value. First, concentrations tend to imply a risk of a decline in revenues due to an interruption of the company's ability to deliver its products or a decline in the demand for its products. Second, they may imply limits on revenue growth through potential market saturation or through limits on the company's productive capacity.

Risk of lost revenues, and hence, of reduced earnings or cash flow, typically leads the appraiser to determine that a higher return is required on an investment in the subject company. The increased return requirement results in a higher earnings capitalization factor (expressed as the required return minus expected earnings growth) and, in turn, in a lower capitalization factor (the reciprocal of or one divided by the percentage capitalization rate). Since value is defined as the product of expected earning power and the capitalization factor in the direct capitalization of earnings approach to valuation, value declines with the factor. Similarly, if the appraiser employs a discounted future benefits methodology with a specific forecast of earnings or cash flow in his appraisal, the higher required return implies the application of a higher discount rate, and hence, a lower net present value for the company's earnings stream.

Limits on growth implied by concentrations lead the appraiser to determine that a higher capitalization rate (the required return minus the growth rate) and hence, a lower capitalization factor (one divided by the capitalization rate) is appropriate. Value, as the product of the capitalization factor and earning power, thus declines. Where a specific forecast of earnings is used, the forecast of lower future earnings stream results in a lower net present value. In some cases the concentrations may imply both a higher risk profile and constraints on growth, negatively affecting all of the key valuation assumptions.

In some cases, the negative implications for value of business concentrations may be substantially or even entirely mitigated by the presence of long-term contractual agreements binding customers and suppliers to the company.

In preparing any valuation analysis, it is essential that the appraiser identify any and all relevant business concentrations, assess their magnitude, recognize any mitigating factors, and reflect the impact of the concentrations in the valuation by adjusting the discount rate, capitalization factor, earnings forecast, or some combination thereof in a logical, measured manner. ◆

# The Relationship Between Size and Value

It is often the case that the value of a business is determined by multiplying the subject company's earnings by a Price/Earnings ("P/E") ratio derived from a group of public companies with characteristics similar to those of the subject company. This "guideline" P/E ratio is often reduced by a discount that is intended to reflect fundamental differences between the guideline companies and the subject company. While there are often many relevant differences between the guideline companies and the subject company, the primary difference is often size. Privately held companies tend to be significantly smaller (in terms of cash flows, assets, etc.) than publicly traded companies.

**If two companies are identical in all respects except size, the stock of the smaller company will most likely be discounted relative to the stock of the large company. This discount is called a *fundamental discount***

If two companies are identical in all respects except size (i.e. expected cash flows, probability of favorable liquidity events, etc.), the stock of the smaller company will most likely be discounted relative to the stock of the large company. Analysts refer to this as a "fundamental discount," and this discount often causes consternation among readers of appraisal reports. The fundamental discount is due to the increased perception of risk associated with smaller companies. It is therefore, important to understand the risks associated with smaller companies relative to larger companies.

The most common sources of incremental risk due to size cited by appraisers include the following:

- ***Access to capital markets***. Large corporations are able to raise money in the public financial markets, and they have a much easier time securing credit than smaller companies. Many smaller companies have trouble securing bank debt unless the loans are personally guaranteed by the shareholders.
- ***Financial and operating strength***. Larger companies generally enjoy more healthy capital structures and are more likely to be perceived as able to weather cyclical economic swings or financial distress. Larger companies are less dependent on a small group of managers, products, or customers. Also, larger companies tend to be more diversified, and it is a basic

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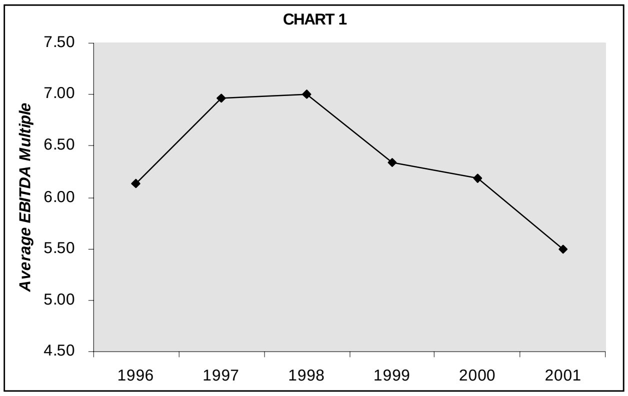


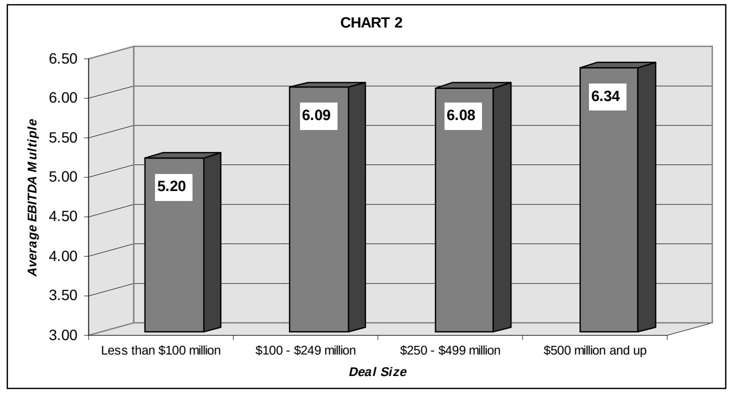


# When Down Is Not Necessarily Down

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2001, the average EBITDA multiple for acquisitions with a total deal size of less than $100 million was 5.20x (S&P Portfolio Management Data, *M&A Today*, June 2001). For even smaller acquisitions, the average EBITDA multiples over the most recent period have probably been closer to 4.0x-4.5x.

What does this data tell us? Is it doom and gloom for business owners that may be looking to sell? Certainly the picture is not all rosy, but it's not *that* bad either. It must be remembered that all investments should be considered within the context of other alternative investments. The value of a certain business may be lower today than it was two years ago, but the value of most companies across the board, including those traded on the public markets, are also lower.

An example should be illustrative. Consider that there are two business owners (we can call them Owner 1 and Owner 2) who each own 100% of perfectly identical companies. For simplicity, we will say that each company has had stable annual EBITDA of $5,000,000 over the past three years.

On January 1, 2000, a financial investor approaches both business owners and offers to purchase each company for cash based on a multiple of 5.5x EBITDA, or $27,500,000. Owner 1, feeling this offer is adequate, accepts and receives $27,500,000 (in this hypothetical world there are no taxes). After much consideration, Owner 1 decides that active trading is not efficient over the long term, so he invests all of his money in an S&P 500 Index Fund. (Of course, most reasonable investors would look for additional diversity, but we are trying to make a point, so bear with us.)

Alternatively, Owner 2 decides that it is not the right time to sell, and thus rejects the offer.

Therefore, Owner 1, essentially traded his company for $27,500,000 invested in the S&P 500, and Owner 2, still owns his company with annual EBITDA of $5,000,000.

Fast forward to November 1, 2001. Owner 1 still holds his investment in the S&P Index Fund, though he has experienced a return of -27.5% during the interim period. Owner 2, on the other hand, has recently agreed to sell his company for a price equaling 4.5x EBITDA (down significantly from the 5.5x that he could have had less than two years ago). Who is better off between the two?

**TABLE 1**

| | OWNER 1<br>Company Sold on<br>January 1, 2000 | OWNER 2<br>Company Sold on<br>November 1, 2001 |
|---|---|---|
| EBITDA | $5,000,000 | $5,000,000 |
| EBITDA Multiple | 5.5 | 4.5 |
| Total Deal Price | $27,500,000 | $22,500,000 |
| Return on S&P 500 Index | -27.5% | |
| **Total Net Worth Today** | **$19,937,500** | **$22,500,000** |

As seen in Table 1, Owner 2 actually comes out ahead. Even with the lower acquisition multiple, the total net worth of Owner 2 (assuming no other investments) exceeds that of Owner 1. Our point is, hopefully, clear. Acquisition multiples are down, but so is nearly everything else.

It is important that business owners who are either actively attempting to sell their company or planning to do so in the future have an accurate picture of the current acquisition environment. In the selling process, it is necessary to have a reasonable expectation of the price your business will command in the market. Without an accurate picture of the current conditions in the market, such reasonable expectations are difficult to develop.

It is dangerous, however, to be too pessimistic. Multiples are down, but there are opportunities for selling. In fact, considering the current public market environment, now may be an opportune time to look for liquidity. Selling for what historically may be a "cheap" price is a good deal when you can reinvest even "cheaper." ◆

## The Relationship Between Size and Value

*(Continued from Page 2)*

financial axiom that diversification decreases risk.

Many smaller businesses rely almost entirely on the abilities of a single manager or a small group of managers. Further, smaller businesses often offer only a single product or a small group of products. And, some smaller companies are supported almost entirely by a single customer or a small group of customers.

- ***Growth factors***. For a variety of reasons, some of which are tied to the factors already listed above, smaller companies generally do not have growth prospects equal to those of their larger peers. A smaller company is disadvantaged when raising the capital necessary to implement a growth strategy, and its smaller management team might find it more difficult to generate ideas for growth opportunities and to effectively manage the growth process. Further, a smaller company with customer or product concentrations will not be exposed to as broad an array of customer problems waiting to be solved and customer needs waiting to be met as a larger company with more representatives talking to more customers.

**The return on an investment is based on the relationship between the purchase price of the investment and the cash flows associated with the investment**

The size of the public company reduces the perceived risk of an investment in the public company due to the factors cited above, and a rational investor in a closely held corporation would therefore demand an incremental return relative to the return on the publicly traded security. The return on an investment is based on the relationship between the purchase price of the investment and the cash flows associated with the investment. The fundamental discount, therefore, reflects this incremental relative return requirement (from the point of view of the hypothetical willing buyer) by reducing the purchase price of the security.

Business owners perplexed by the application of a fundamental discount to the multiples applied to their companies should carefully consider the factors cited above. If an appraiser applies a fundamental discount to a P/E ratio based on an examination of public companies, it is likely that the public company is considerably larger than the subject company and enjoys the advantages associated with size described above.

For more information or to discuss a valuation issue in confidence, please give us a call. ◆

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