

ADVICE

The IE Business Doctors Eugene E. Valdez and Ted Collins

Tips for managing your business value in difficult times

To understand how the credit crisis and recession have impacted the value of privately owned companies, we have to survey the broad market for mergers and acquisition (M&A). Looking over the past three years we have seen significant shifts in the M&A marketplace.



Ted Collins

Two key measures that are used are deal volume, which measures the number of deals, and aggregate deal value, which captures how much was being spent to acquire companies.

According to FactSet, both volume and value reached highs in 2007. If we compared June 2007 data with June 2010, we can see that volume decreased from 942 deals to 800 deals and value decreased from \$124 billion to \$61 billion. This decreased activity can also be seen in middle market (deals with values between \$1 to \$500 million) company pricing multiples.

One common pricing multiple is Price to EBITDA (Earnings before interest, tax, depreciation and amortization). In 2007, Price to EBITDA peaked at nearly 12 times. In the second quarter of 2010, the price to EBITDA is 8.4 times. This means that if you had a company that had EBITDA of \$4 million, the value of your company would have declined from \$48

million (12 times \$4 million) to about \$34 million, a decline of 30 percent. Of course one cannot use such broad measures for specific companies, but it illustrates how company value has been impacted.

It is important for business owners to recognize that valuation is both art and science. A business value largely rests in the eyes of the beholder and given the challenging environment for M&A it just makes sense for an owner to pay some attention to how value might be perceived by a buyer.

Regardless of economic conditions, value is a function of the cash flows being generated by a business divided by an expected rate of return. This formula, though simple mathematically, is quite complex when its implications are unpacked. Cash flow has been impacted negatively in this recession for most businesses, which serves to lower value. Most owners are justifiably devoting their attention to the important tasks of ensuring revenues are at least maintained and expenses controlled.

However if cash is king, risk would be his queen. The valuation formula expresses risk as the rate of return required by an investor. Risk is equally important when it comes to calculating a business value. To drive value up, an owner needs to lower risk in the business. This can be done in many ways, all

of which serve as evidence that the business is being managed well.

If we start our search for risk at the top, one common concentration of risk is the owner. Is the owner responsible for a disproportionate amount of operational knowledge or key relationships that are not easily transferable? In many instances this indicates risk is higher than for a business with a management team in place that shares those responsibilities.

Another area often overlooked is financial performance measures. If an owner has never compared financial performance to benchmark data, then much of the story in the numbers is not being understood and managed.

A buyer would compare key financial data against industry benchmarks and the company's historical patterns to identify risk areas. Key indicators such as inventory turns or collection days show how well a company is being managed.

Identifying problem areas and addressing them will make a company look better to a buyer which establishes credibility and lowers perceived risk. Lowered risk in turn, drives value higher.

Spending quality time thinking about the business and its risks can really help an owner to build value, whether or not a sale is planned. It just makes good business practice.

About The IE Business Doctors

The IE Business Doctors are a strategic alliance of about a dozen Inland-based business experts from a variety of disciplines who meet twice monthly to mentor each other and share best practices. This column is geared toward sharing information with small business owners. For more information about The Business Doctors, contact Eugene E. Valdez, Vice President-Senior Relationship Manager of Community Bank in Ontario via evaldez@cbank.com. Opinions expressed by the authors are their own personal opinions and not the opinions of Community Bank.



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