



## *Why a Valuation is the Place to Begin*

Understanding the value of your company is fundamental to understanding how to create value. Most business owners want to maximize their company's value, regardless of whether they plan to continue operating the business for years or exit in the near term. They also recognize that each business decision either creates or destroys value. A business owner with a "value-creation-based" plan will be best equipped to maximize his or her company's equity value and negotiate the most attractive terms when the time comes to achieve partial or complete liquidity for their ownership in the company they founded and/or built.

## *All Vesticor Engagements Begin With A Valuation*

A valuation is an assessment of a company's fair market value and serves as an important starting point for surveying strategic alternatives. Once you know how much your company is worth, you are much better positioned to answer important business questions such as:

- Can I afford to give equity to my key management team members? Can I afford not to?
- Can I achieve my personal financial objectives and keep control of my business?
- How much equity do I need to give up if I want to bring in an equity partner to fund growth?
- If I sell my company, can I achieve my personal economic and non-economic objectives?

This Vesticor Advisors Report is designed to provide a high-level introduction to the valuation process for prospective clients who want to better understand the factors likely to influence a company's valuation – positively or negatively – as well as the basic components of a valuation analysis. Please feel free to contact us for specific advice, to further discuss valuation, or to learn how we work with private business owners to create a customized solution that will successfully achieve economic and non-economic objectives.

## What Drives Value?

Value drivers are behaviors that can both reduce risk and improve return. A business with a successful “value-creation-based” plan often receives a premium valuation relative to its peers. Lenders also offer more favorable terms and investors pay more for minority or majority equity stakes in such a company.

While there are many behaviors that create value within a business, the following list is common to almost all industries:

***Management as Foundation for Value Creation.*** A company’s management team is responsible for setting strategic objectives, monitoring performance and motivating the workforce. Because of the challenge inherent in assembling a good team and motivating them toward a common goal, the management team typically is considered to be one of a company’s most important value drivers.

The size of a management team can vary depending on the size of the business. In the smallest firms, the senior management team may consist of only one person – the owner. For a potential lender or acquirer, the risk associated with backing a one-person management team will far outweigh that individual’s track record in managing the firm’s growth. If the business is perceived as dependent upon the owner’s personal relationships and reputation alone, lenders are likely to impose onerous terms and investors will be unlikely to pay a premium price for all or part of the company.

A strong management team increases the likelihood that a company will have continued success after the close of a transaction. A leadership team with broad and complementary skills is a significant asset to any investor. But talent alone is not enough. The management team must also have staying power and/or a clear plan of succession. Owners or key managers who plan to exit following the close of a transaction may negatively impact a buyer’s valuation of a company unless there is a strong succession plan in place or the buyer has overlapping management capabilities. By contrast, management teams that are committed to the business and motivated to continue its growth can inspire a buyer to pay a premium for a company.

***Can Past Operating Successes Be Understood and Replicated?*** A business’ operating systems include the automated and manual processes used to generate revenue and control expenses, as well as methods that track how customers are identified and how products and services are delivered. Establishing and documenting such procedures demonstrates to a potential acquirer that the business can be maintained and grown profitably after a transaction.

***Financial Reporting Must Support Growth Trends and Profitability.*** Reliable financial statements that provide the detailed information necessary to understand the business provide credibility with lenders and potential buyers. Audited financial statements further strengthen confidence in the company and should be provided whenever practicable. If a buyer has confidence in the reliability of a company’s financial statements, the due diligence process is smoother, the buyer is more likely to invest in or acquire the company and more likely to offer a price that fully reflects the value that has been created in the business.

***Customer Concentration Can't Be Too High.*** Another key value driver is possession of a customer base in which no single client accounts for too high a percentage of total sales. High customer concentration is always a concern for potential investors because a change in ownership could negatively affect contracts or customer relationships, resulting in a loss of revenue. When there is customer concentration, it is important to demonstrate the steps management has taken to reinforce those relationships.

***Is the Growth Plan Compelling and Consistent With Historic Results?*** A favorable growth strategy is important but to truly create value it needs to be clear, well communicated and easy to understand relative to the company's historical performance, industry and capabilities. Potential acquirers rarely understand a business as well as the current owner/management team, and may not fully appreciate its growth potential. Often, it helps to frame a growth strategy around one or more key factors that include industry expansion, increased demand for existing products/services (particularly if the demand is driven by well-established macro-level trends like demographic growth), the development of new products/services or enhanced manufacturing capacity. Regardless of the basis of the growth strategy, a management team must be able to communicate clearly the specific reasons why cash flow and the business itself will be positioned to grow profitably after the transaction. Keep in mind that stability of growth goes hand-in-hand with outright growth. If a company grows consistently year after year, it will generally be worth more than the company that ultimately achieves the same growth but does so with years that are low/no growth (higher volatility of earnings).

***Size Matters.*** As a general rule, the smaller the business, the lower the multiple (or overall valuation) applied to the business. There are several reasons for this. At the top of this list is the fact that there are fewer buyers looking for smaller businesses (less liquidity) and those tend to be hyper-regional – they tend to buy businesses near where they live or want to live. Secondly, the amount of work required to buy a \$2M enterprise value business is generally the same as the amount of work to buy a \$100M enterprise value business. This work often consists of out-of-pocket attorney/accounting costs. These costs can make the purchase of a \$2M business much less attractive.

***Proactive Due Diligence is a Key.*** One of the primary skills that a strong M&A advisor can bring to a transaction is assistance with proactive due diligence focused on identifying key investment merits, potential concerns and an accompanying analysis of the company's true earnings capacity. At Vesticor, we work with clients to present their company's current earnings with appropriate adjustments for non-recurring items as well as a base case of projections that represent management's most likely scenario for company growth in revenues and profitability over the next five years. We challenge owners and management teams to create a thoughtful, defensible scenario – not an overly conservative "base case" and not an overly optimistic "upside scenario." We then work with management to position the company's growth strategy in a manner that demonstrates how the company is likely to capitalize on growth opportunities while mitigating potential risks.

*Private  
Company  
Valuation*

**So, how to determine the value of a privately held company?**

Ultimately, valuation is the price at which a willing seller is willing to sell, and a willing buyer is willing to buy. In the public markets we know the answer to valuation for any given company, because there exists a “liquid” market where buyers and sellers meet for instantaneous transactions related to the value of the company. For private companies, there is no market – there is no liquidity. Because of this, we must estimate a value based on several valuation methodologies. This process will only yield an estimate of value. The only true way to establish an accurate valuation for your business is to create liquidity. This is accomplished via a process whereby Vesticor brings as large a group of willing buyers to the table to replicate that liquidity. We work with literally thousands of private equity firms, family offices, ultra-high-net-worth individuals, independent sponsors and strategic buyers to create the best outcome for our clients.

Keep in mind that valuation is only one aspect to the “offer” and sometimes not the most important. This is especially true for private companies. For public companies, the seller of a non-core division of that company is the CEO. He or she is motivated by maximizing shareholder value (valuation). The CEO is far less interested in the impact on the community, employees and other stakeholders. For private companies, these are all material considerations. As such, some buyers will be aligned with your intentions regarding these intangible and others won't.

Furthermore, structure is important. It is highly unlikely that the buyer of a private company will simply write the seller a check. The purchase price may include a seller note, retained equity or strap the business with an uncomfortable amount of debt. The structure can make even the highest valuations look less attractive. Once again, by bringing a large number of willing buyers to the table, Vesticor enables you to not only achieve maximum value but the structure and the “fit” that meets your ultimate goals. At Vesticor, we work exclusively with private companies. This focus helps us understand the changing nuances of the market for these companies and ultimately results in the best outcome for our clients.

## Valuation Methodologies

A company with a well-communicated and effective “value-creation-based” plan is less likely to be subject to a substantial valuation discount relative to its public company peers. In fact, a uniquely profitable company with above average growth prospects may even command a slight premium, although that is relatively rare. Discounts and premiums are highly subjective, as there are no hard and fast rules on how to apply them or how large they should be. As such, the process of estimating an appropriate private company discount or premium requires a solid understanding of a number of key differences between private and public companies that impact value:

- **Market Liquidity** - A public company’s stock trades actively on an exchange, providing a constant source of liquidity to shareholders as well as a benchmark for valuation. Private company equity is illiquid as shares are not actively traded on an exchange and thus will often require a discount. However, it should be noted that public company stock quotes reflect the value of individual shares and therefore provide a non-control valuation for a company. As there is often a premium paid for control of a company, sometimes the premium for control of a private company may roughly cancel out a discount for lack of liquidity.
- **Size** - Private companies are typically smaller than their publicly traded counterparts. The degree to which size contributes to the magnitude of a potential private company discount is dependent upon the drivers of the company’s size. For instance, size can be an indication of growth stage with an unproven start-up company and require a discount that would not be needed in the case of a more mature company with a proven track.
- **Business Mix** - Private companies are often niche-oriented while their public counterparts have a more diversified product mix. Concentrating operations in a limited number of product lines may be a source of risk or it may be a source of competitive advantage. Unless there are mitigating benefits of specialization, a limited business mix may require a discount applied to the valuation.
- **Management** - Control in closely-held companies is most often concentrated among a limited number of individuals. Management issues can include:
  - A small available talent pool from which to grow the management team;
  - The lack of a succession plan to ensure continuity should key personnel leave;
  - In cases of family-owned businesses, internal conflict over operational control.

All these issues can be associated with increased business risk and consequently may require a discount placed on a private company relative to its public company peers. Again, with private companies that are not subject to these issues, the valuation may not be subject to any discount and may, in fact, justify the rare premium.

*Comparable  
Company Valuation*

A Comparable Company valuation exercise provides a set of benchmarks used to estimate the relative market value of the company under consideration.

Selection of comparable companies is generally based on the following criteria:

- Sector / Industry
- End-Markets Served
- Operational Characteristics
- Size
- Financial Health
- Margins
- Growth Rate
- Location of Operations

Once an appropriate set of comparable companies has been selected, the financial statements of each firm should be adjusted to eliminate any extraordinary items. The most common benchmarks used to calculate value using the Comparable Company method are multiples of revenue, EBITDA and EBIT. Different business models and industries have different trading characteristics. For instance, high growth companies that are investing in their cost structures to spur growth may be more likely to trade as a multiple of revenue. A more established business with a more mature growth profile and cost structure may trade as a multiple of EBITDA or EBIT. Finally, companies in an industry that has widely divergent capital expenditures might trade as a multiple of EBITDA less capital expenditure.

An average or median value of each multiple is typically used since it is uncommon that any one comparable company has the exact characteristics of the subject company. At Vesticor, we often consider 20-100 potential comparable companies before we can narrow down to 5-20 publicly traded companies that are most applicable.

*Comparable  
Transaction  
Valuation*

A Comparable Transaction valuation exercise involves the analysis of the qualitative and quantitative details of a merger or acquisition transaction involving target public companies that are comparable to the subject company. As with the Comparable Company method, multiples of revenue, EBITDA and EBIT derived from the set of comparable transactions are applied to the subject company's financial performance metrics.

A key objective in selecting comparable transactions is to find the most comparable target businesses. As with the Comparable Company valuation analysis, comparable target companies should operate in similar industries with similar products or services as the subject company. Size, margins, relative market position and major potential liabilities should also be considered. The situation surrounding the transaction can also be crucial. Transaction scenarios such as LBOs, hostile transactions, reverse mergers, asset vs. stock acquisitions and form of consideration will have differing implications with regard to valuation. Recent deals are typically a more accurate reflection of the values buyers are willing to pay. Acquisitions of minority interest and rumored or withdrawn deals generally should not be considered as comparable transactions.

Several key items that must be considered when performing a Comparable Transaction valuation exercise include:

- The valuation multiples may include a premium or discount associated with the company, industry or timing of a particular transaction which may not be appropriate to apply to the subject company;
- The valuation multiples may be premised on synergies of a magnitude not applicable to the subject company;
- The valuation multiples may be dated and not reflect current market conditions.

Thorough qualitative analysis of each comparable transaction is required to make a Comparable Transaction analysis truly meaningful to a company considering a transaction. As with a Comparable Company analysis at Vesticor, we often begin with a large set of transactions that have taken place within the past few years and use our judgment – through years of operational and transactional experience to narrow the comparison set to generate the most meaningful results for our client.

### *Discounted Cash Flow Valuation*

The Discounted Cash Flow (DCF) valuation method values a business based on its future expected cash flows discounted at a rate that reflects the perceived riskiness of the cash flows. A DCF is one of the most fundamental and widely-used valuation techniques. This method is more flexible than other valuation methods in considering the unique circumstances of a company, but it is also very sensitive to estimates of cash flow over the near term (typically 5 years), terminal value (an estimate of cash flows likely to be generated in outer years) and the discount rate.

The major components of a DCF valuation are:

- **Projections:** Operating results and after-tax free cash flows of the business should be projected out as far into the future as can reasonably be estimated to reduce dependence on the terminal value (industry practice is 5 years).
- **Terminal Value:** The terminal value represents a company's value at the end of the projection period and is typically based on some measure of the performance of the business in the terminal year of the projection. A growth rate in perpetuity of after-tax free cash flows may be used to calculate the terminal value. Typically this perpetual growth rate can be a historical or average growth rate for the industry, target firm, or overall economy.
- **Discount Rate:** The discount rate represents the required rate of return given the risks inherent in the business, its industry and thus the uncertainty regarding its future cash flows, as well as its optimal capital structure. Typically the weighted average cost of capital (WACC) will be used as a foundation for setting the discount rate. The WACC is typically estimated by studying capital costs for public companies that are similar in nature and risk to the one being valued.

*Leveraged Buyout  
(LBO) Valuation*

- **Present Value:** The discount rate is used to determine a range of values for the enterprise by discounting the projected free cash flows and terminal value to the present.
- **Adjustments:** The resulting valuation range should be adjusted for any assets and liabilities not accounted for in the cash flow projections.

The fourth and final valuation methodology is a leveraged buyout analysis. Typically an LBO analysis provides a “floor” valuation for a company as it considers what a buyer would be willing to pay for a business when utilizing a leveraged capital structure and pricing an equity return that appropriately compensates the buyer for the risk associated with such leverage.

Similar to a DCF, an LBO analysis utilizes a company’s most realistic projection of five-year financial performance. Once this “realistic” case is established, a financial buyer will analyze the impact of an “upside” case and a “downside” case to establish the impact on their investment return.

Based on discussion with lenders, the financial investor will determine the amount of total senior and subordinated debt that can be obtained from the market as well as the pricing of that debt. The total debt available from the market will depend on a number of internal and external factors including the size and financial performance of the company as well as the overall health of the economy and availability of credit. The lender will also require a minimum amount of equity as a percentage of the total capital structure in order to align the buyer’s interests with those of the lender. Typically, financial buyers will determine the total value based on a financial analysis that incorporates the five-year projections and a required equity return ranging from 20-25% compounded annually, incorporating:

- the amount of debt that can be borrowed;
- how long it will take to pay off the debt using the company’s projected cash flows;
- the likely return to the investor who supplied the initial equity investment.

An LBO analysis can be quite complex and is very sensitive to current financing markets. Vesticor professionals utilize an up-to-the-minute understanding of debt markets as well as a proprietary understanding of specific investor appetite for acquisitions in order to create a highly refined analysis of a client’s debt capacity and the likely return that will be demanded by investors providing the equity.

*Conclusion*

At Vesticor, we approach each valuation analysis as an opportunity to develop a highly refined and very realistic opinion as to the range of values you are likely to receive for your company from prospective purchasers in today’s market – minority or control, strategic or financial. We view our initial valuation analysis as an opportunity to facilitate client decision making regarding an upcoming transaction and to establish appropriate mutual expectations. Please give us a call to further discuss your potential transaction. We are happy to answer any questions you might have about evaluating your company’s value.

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with Vesticor*

*Vesticor Advisors provides M&A and capital raising advisory services exclusively to closely-held companies in the lower and middle markets. Vesticor was founded on the principle that owner-operated companies in the lower middle market are unique and require specialized advice when considering strategic investment and exit opportunities. Vesticor addresses the needs of entrepreneurs, founders and shareholders of private companies by bringing a differentiated perspective to client engagements through experiences as company founders, operators, investors and advisors.*

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