

VALUATION CONSIDERATIONS

When Buying or
Selling a Business



SKODA MINOTTI

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Introduction

“There is no such thing as an absolute value in this world. You can only estimate what a thing is worth to you.”

-Charles Dudley Warner, American Writer

If you have ever bought or sold an asset of any meaningful size, such as your home, you have learned the lesson illustrated by the above quote. Value is a concept that is very much in the eye of the beholder and is particularly important for buyers and sellers of closely-held businesses. There are many considerations when contemplating the purchase or sale of a business, including purchase price, deal structure, tax considerations, legal considerations and so forth.

A closely-held business is often the centerpiece of the owner’s life’s work. As a seller, this makes for a very personal decision, not to mention a financially complex one. On the other hand, purchasing a business comes at a significant cost and capital outlay to the buyer, so appropriately valuing the target company is critical to minimize the likelihood of overpayment. Whether you are the buyer or seller, it is essential to understand the valuation concepts that drive the ultimate purchase/sale price.

This e-book will help you understand the following valuation concepts that are important to consider in Mergers and Acquisitions transactions:

- Standards of Value: Strategic Value vs. Fair Market Value
 - Normalizing Adjustments
 - Buyer-Specific Synergies
- Deal Structure
 - Stock Deal vs. Asset Deal
 - Earnouts
 - Working Capital Considerations

If you are interested in learning more about how these issues impact company valuation and deal prices in Mergers and Acquisitions transactions, we invite you to continue reading this e-book.



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Standards of Value – Strategic Value vs. Fair Market Value

The critical departure point for understanding business value in the context of an acquisition is the standard of value. The standard of value facilitates the transaction by setting a framework for the buyer and seller. In a merger or acquisition, two standards of value are often considered – fair market value (“FMV”) and strategic value (“SV”). Fair market value represents the value of the business if it were to be sold to an unrelated third party. In general, fair market value sets the floor value as to what an acceptable transaction price may be for the seller. Because the fair market value standard presumes a hypothetical financial buyer, there are generally no synergies assumed in the business’s value or deal price. A financial buyer’s evaluation of a company generally centers on its ability to generate cash flows



and the risk associated with achieving those cash flows. In other words, the financial buyer simply wants to purchase the business “as-is” and continue its operation. In contrast, strategic value (i.e. investment value), involves the consideration of factors that are specific to a prospective buyer of the company. These factors, such as redundant expense elimination or cross-selling opportunities, can generally be captured by adjusting the target company’s cash flows for the expected impact of these buyer-specific synergies.

The process by which a valuator (or the buyer, seller, or any other interested party) estimates the sustainable, repeatable level of cash flows of a target entity is called a normalization analysis. Depending on the standard of value being used, the following types of normalizing adjustments are typically considered:

- 1. Adjustments for discretionary items** – Discretionary expenses are those that are incurred at the direction of a company’s owners, but which are not necessary for the operation of the business. One common discretionary adjustment is for owner compensation in situations where the owner may be taking more (or less) salary than the fair market value of the services he or she provides to the company. Other examples of adjustments that fall into this category might be rent paid to a related party at other than market levels or excess owner benefits (e.g. personal auto, travel or entertainment expenses). This type of adjustment is appropriate in both a fair market value and strategic value context.

2. Adjustments for non-recurring items – These adjustments relate to one-time income or expense items that are typically identified through analysis of trends in a company’s historical income statements. Examples of non-recurring items might be a one-time charge for a litigation settlement, relocation expenses required to lure a key employee, or transaction costs associated with the purchase of a company. This type of adjustment is appropriate in both a fair market value and strategic value context.

3. Adjustments for synergies – These adjustments are based upon perceived changes (typically increases) in cash flows that are expected if an acquisition occurs, such as revenue enhancement through cross-selling or expense reduction due to the elimination of redundant expenses. Synergistic adjustments are generally more subjective than those discussed above. While a valuator can certainly estimate the impact of such adjustments on the company’s cash flows, there are a few factors that need to be considered when making adjustments for synergies.



First, these items can be very speculative in nature because there is often limited, if any, historical data to support the adjustment. This speculation creates uncertainty in the likelihood of achieving the expected synergies, which may in turn may increase the risk of the projected cash flow improvements. Second, because synergy adjustments are buyer-specific, a seller preparing a valuation analysis can only estimate what it believes a particular buyer may expect to generate as far as synergies. Third, just because synergies may be present, it doesn’t necessarily mean that a buyer will be willing to compensate the seller for them. Instead, the buyer may try to minimize the amount it is willing to pay for any expected synergies in an effort to increase its return on investment, particularly if there are no other active buyers in contact with the target company at that time. Nonetheless, in an Mergers and Acquisitions context, these are very real factors that should be considered by the parties.

The table on the following page is a helpful tool in understanding how the classification of a given adjustment could impact the cash flows of a target company depending on whether a fair market value or strategic value standard is being used.

NORMALIZING ADJUSTMENTS						
FAIR MARKET VALUE VS. STRATEGIC VALUE						
	12/31/X1		12/31/X2		12/31/X3	
	Amount	Percent	Amount	Percent	Amount	Percent
Revenues	\$ 4,000,000	100.0%	\$ 4,500,000	100.0%	\$ 5,250,000	100.0%
Fair Market Value Normalizations						
Historical Pre-Tax Net Income	\$ 550,000	13.8%	\$ 650,000	14.4%	\$ 775,000	14.8%
Normalizing adjustments						
Auto Expense - Discretionary	25,000		25,000		25,000	
Excess Owner Compensation - Discretionary	150,000		150,000		150,000	
Office Rent - Discretionary	65,000		65,000		65,000	
Membership Dues - Discretionary	10,000		10,000		12,500	
Relocation - Non-Recurring	-		-		15,000	
Other Income - Non-Recurring	(20,000)		-		-	
Normalized Pre-Tax Net Income - FMV	780,000	19.5%	900,000	20.0%	1,042,500	19.9%
Less: Income Tax Expense (35%)	(273,000)	(6.8%)	(315,000)	(7.0%)	(364,875)	(7.0%)
Normalized After-Tax Net Income - FMV	\$ 507,000	12.7%	\$ 585,000	13.0%	\$ 677,625	12.9%
Strategic Value Normalizations						
Normalized Pre-Tax Income - FMV	\$ 780,000	19.5%	\$ 900,000	20.0%	\$ 1,042,500	19.9%
Normalizing adjustments - Strategic Value (SV):						
Enhanced Revenue Opportunities	150,000		150,000		150,000	
Staff Redundancies	65,000		65,000		65,000	
Office Rent Redundancies	130,000		130,000		130,000	
Normalized Pre-Tax Net Income - SV	1,125,000	28.1%	1,245,000	27.7%	1,387,500	26.4%
Less: Income Tax Expense (35%)	(393,750)	(9.8%)	(435,750)	(9.7%)	(485,625)	(9.3%)
Normalized After-Tax Net Income - SV	\$ 731,250	18.3%	\$ 809,250	18.0%	\$ 901,875	17.2%

Note that under an FMV standard, the historical normalized after-tax net income of the target ranges from \$507,000 to \$677,625. After layering in synergistic normalizations, the historical normalized after-tax net income jumps to a range of \$731,250 to \$901,875. This increase in cash flows can have a significant impact on the value of the company and the price a buyer may be willing to pay (to better understand the impact of cash flows on the indicated value of a business, download our [How a Company is Valued](#) e-book). It stands to reason that the buyer who has the ability to unlock additional cash flow in the form of synergies may be willing to pay a premium over what a financial buyer may be willing to pay who could not capitalize on those opportunities. While the approximately \$200,000 difference in cash flows is significant, these synergies can be much greater than the example. Consider the analysis we presented on Facebook's acquisition of [Whats App](#). In the example, however, the indicated values under fair market value and strategic value are still quite different. If we use the most recent year's after-tax net income (\$677,625 under FMV and \$901,875 in SV) as the expected level of cash flow going forward, we can see how far apart these values can be. If we hold the capitalization rate constant at 20% in the FMV and SV scenarios, the implied value in FMV scenario is \$3.4 million (\$677,625 / 20%) compared to that of the SV scenario of \$4.5 million (\$901,875 / 20%) – a \$1.1 million difference!

In addition to the potential size of any synergistic normalizing adjustments, the parties must also consider the measurability of those synergies. So, beyond the size of the benefit, the parties should also consider how likely it is that the company will achieve those synergies post-acquisition. A benefit that is highly likely to be achieved will obviously result in a higher perception of value than one that is believed to be less achievable. An additional challenge in terms of measuring synergies is determining the timing of realizing those benefits. In the example above, enhanced revenue opportunities are expected to create \$150,000 of additional cash flow per year. However, the buyer will also need to consider how long it will take to secure that extra revenue. It could be immediate, but in most cases, the realization of such a benefit is gradual over a period of time. By assuming the benefit occurs immediately, the buyer may be overvaluing that benefit. If this benefit is overvalued, it may lead a potential buyer to overpay for an acquisition.

The parties may also consider the impact of including speculative synergistic cash flows in the analysis when determining the appropriate rate of return. The challenges in estimating the cash flow impact and the lack of historical data surrounding these adjustments would seem to suggest a higher discount rate is appropriate. All of these factors will impact the parties' perception of the reasonableness of the expected cash flows, the riskiness of the investment, and ultimately, the company's value in the form of an acceptable purchase price.

Deal Structure

Asset Deal vs. Stock Deal

While the focus of the buyer and seller is typically on the purchase price, the structure of the deal is critical to the economics of the transaction for both parties. Because there are competing interests between structuring a transaction as a stock or an asset deal, the purchase price can be impacted and is sometimes adjusted based on how a deal is ultimately structured.

There are three primary reasons that parties negotiate for asset or stock deals (depending upon what side of the table they are sitting on): tax issues, liability issues, and depreciation / amortization issues. The general pros and cons related to these issues for buyers and sellers are summarized below:



Tax Issues – It is generally in the seller’s favor from a tax perspective to structure the transaction for the sale of a C corporation as a stock deal because the proceeds are only taxed once (as capital gains at the personal level for the owners). On the other hand, in an asset deal, the proceeds from the sale are taxed twice: once at the company level and again at the owner level upon distribution. Therefore, the dollars that end up in the seller’s pocket at the end of the day are far less in an asset deal than in a stock deal, as evidenced below (assuming there is no basis in the stock or assets and there are no NOLs). For simplicity, capital gains and dividend rates are assumed to be 20% for this example.

ASSET DEAL VS. STOCK DEAL		
	<i>Asset Deal</i>	<i>Stock Deal</i>
Deal Price	\$ 10,000,000	\$ 10,000,000
Corporate Level Tax (35%)	<u>(3,500,000)</u>	-
Cash Available to Distribute	6,500,000	-
Dividend Tax (20%)	(1,300,000)	-
Capital Gains Tax (20%)	<u>-</u>	<u>(2,000,000)</u>
After-Tax Proceeds to Seller	<u>\$ 5,200,000</u>	<u>\$ 8,000,000</u>

As you can see, there is a \$2,800,000 difference in the after-tax proceeds to the seller depending upon whether the transaction was structured as an asset deal or a stock deal. That is nearly 30% of the total deal price. Reflecting on the example, it is easy to see how a \$10 million asset deal is not the same as a \$10 million stock deal and why sellers favor stock deals so heavily.

Liability Issues – If the same \$10 million is coming out of the buyer’s pocket regardless of whether the transaction is an asset deal or a stock deal, then why aren’t all transactions stock deals? One major reason is liability issues. It is in the buyer’s favor to structure the transaction as an asset deal because any contingent liabilities that may exist for the target company as of the transaction date stay with the target company (they generally do not transfer to the acquirer with the purchased assets). Therefore, there is much less risk that an unknown liability will surprise the buyer after the transaction has been completed. Essentially, in an asset deal, a buyer is able to shield itself from legal liabilities that arise from the seller’s actions prior to the transaction date.

Depreciation/Amortization Issues – In addition to the liability issues, buyers also favor asset deals because they allow them to amortize any intangible assets or goodwill acquired in the deal when computing taxable income. Further, any fixed assets acquired in an asset deal are written up to fair market value, allowing for full depreciation of the value of these assets for tax purposes. In a stock deal, the buyer takes a carryover tax basis in the business’ assets. As a result, it is not uncommon for the acquired fixed assets, intangible assets and/or goodwill to have little or no tax basis, resulting in little or no depreciation or amortization expense for tax purposes. Therefore, it is more beneficial for a buyer to structure a transaction as an asset deal when there are fully depreciated fixed assets or intangible assets/goodwill associated with the transaction.



As discussed, there are pros and cons to each party in a transaction depending upon whether it is structured as an asset deal or a stock deal. The overriding forces in the sale of C Corporations typically result in buyers favoring asset deals and sellers favoring stock deals. During the negotiation process, it is important to understand the benefits not only to you, but also to the other party, so that a mutually beneficial deal structure can be achieved.

If the entity being sold is taxed as a flow-through entity (S Corporation, LLC, Partnership), there are other considerations that must be addressed when making the asset/stock deal decision. Specifically, there are certain elections that may be made to allow favorable tax treatment to both the buyer and seller. It is important to discuss these options with a tax advisor knowledgeable in this area to give yourself access to all of the tools available for favorably structuring a transaction from a tax perspective.

The Use of Earnouts in Acquisitions

In addition to choosing between an asset/stock deal, there are a host of other mechanisms that can impact a deal negotiation. One such mechanism is the use of an earnout as a component of the consideration in the deal. For example, a deal may include a \$20 million cash payment and an earnout that calls for an additional \$5 million to be paid over the next two years if certain EBITDA (earnings before interest, taxes, depreciation and amortization) targets are met. Earnouts are often used in transactions to bridge the gap between what a buyer is willing to pay up front and what a seller wants in the way of total consideration to complete a deal. Therefore, earnouts are typically constructed to allow the seller to enjoy additional upside if the acquired company reaches certain performance targets after the sale while providing the buyer with downside protection in the event that the projected performance after the deal closes does not materialize. In short, earnouts offer flexibility and allow the parties to “wait and see” how operations progress after the acquisition.

While earnouts are commonly used in transactions, many buyers are not aware that when they purchase a company in a deal that includes an earnout, generally accepted accounting principles (GAAP) require a liability for the earnout to be recorded on the balance sheet. In order to value the earnout, the likelihood of the earnout being achieved needs to be considered. For an earnout with a high likelihood of being realized and short payout period, the recorded liability will generally be close to the maximum payment amount (albeit slightly lower than the maximum to account for the time value of money). For riskier earnouts that stretch over longer periods, consideration needs to be given to the risk of the earnout being achieved and the amounts that would be paid under the most likely scenarios. In these cases, the recorded earnout liability is typically much lower than the maximum amount that could be paid under the agreement.



Once an earnout liability is recorded on a company’s books, it is not adjusted later if the original earnout estimates prove to differ from reality. Rather, the difference between the actual payments and the originally estimated liability are run through the income statement as a gain or loss. This may bias acquirers to overstate earnout liabilities since they will be able to record a gain in the event that the actual payments are less than those estimated when originally valuing the earnout liability.

We have had a number of clients who have been surprised to find out that certain mechanisms that look like earnouts do not qualify for earnout treatment for accounting purposes. Let’s go back to our original example - a deal that includes a \$20 million cash payment and an “earnout” that calls for an additional \$5 million to be paid over the next two years if certain EBITDA targets are met. If we throw in one additional wrinkle – the fact that the sellers must still be employed by the acquirer for a certain period of time (typically until the earnout payments are made) – GAAP actually precludes earnout treatment for these payments. Instead, they must

be recorded as compensation expense, which can have a significant impact on earnings. It is important to keep this in mind when structuring earnouts and balance the benefits and drawbacks of this unique rule. Otherwise, the acquirer may end up having to record a much higher amount of future compensation expense for payments that would have otherwise been recorded as goodwill on the purchase date.

Aside from the accounting issues, there are other challenges when using earnouts as part of the consideration in purchasing a business. For example, settling upon an agreeable profitability metric from which to derive the earnout can be difficult. Potential metrics include revenue, EBITDA, net income, etc. No matter what metric is selected, there will be risks that must be considered. In a case where revenue is used, the earnout will be paid out irrespective of the company's overall profitability. So, if expenses increase at a higher rate than expected, the buyer will essentially get hit twice – once for the inherent lack of profitability of the business and then a second time by having to pay an earnout despite the fact that profitability was worse than originally expected. Using a more profit-focused metric (i.e. EBITDA, net income) also has challenges. Because there are so many components to net income, this metric is more susceptible to manipulation. Due to these risks and challenges, it is critical that the earnout is well-defined in the agreement, perhaps with accompanying example computations.

Earnouts often help buyers and sellers reach agreements that protect the interests of both parties. When an earnout is present in a deal, companies must be aware that they will likely need to record a liability equal to the fair value of the projected earnout payments. They must also keep in mind, however, that if the earnout payments are contingent on the seller's future employment with the acquirer, traditional earnout treatment is thrown out the window for accounting purposes and the contingent payments are generally expensed as incurred.

Working Capital Considerations

The treatment of net working capital (typically defined for transactions purposes as all non-cash current assets less all non-debt current liabilities) can be a topic of debate in potential transactions. We often see that buyers and sellers disagree over how net working capital figures into the purchase price. For example, sellers may believe that they should receive the value of their company based on income or market-based valuation approaches plus be able to retain any net working capital of the business (which in many cases is comprised primarily of uncollected accounts receivable). The issue with this approach is the fact that the value of a company based on income or market-based valuation approaches is dependent upon the company being delivered to the buyer with a sufficient amount of net working capital to continue business as usual.

Delivering a company with no working capital (because the seller has retained these assets) results in the buyer needing to fund this working capital shortfall out of its own pocket, which would effectively increase the purchase price. Knowledgeable buyers, however, will not pay full price for a company that will not be delivered with the level of net working capital necessary to operate the business effectively. A certain level

of net working capital is required to support a business' sales levels. Companies typically operate with a certain amount of accounts receivable, inventory and prepaid assets which are offset by accounts payable and accrued expenses. Therefore, it is common that working capital targets are set in purchase agreements that call for a specific amount of working capital to be present at closing. To the extent that the target company's actual net working capital on the closing date is above or below the target, the purchase price is increased or decreased accordingly on a dollar-for-dollar basis.

The following example illustrates how differing levels of working capital at the closing date can impact the value of a company's equity.

Discounted Cash Flow Method Example							
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	
Growth Rate		15.0%	15.0%	10.0%	5.0%	3.0%	
Revenues	\$ 30,000,000	\$ 34,500,000	\$ 39,875,000	\$ 43,842,500	\$ 45,824,625	\$ 47,199,364	
EBITDA Margin	10.0%	10.5%	11.0%	11.5%	12.0%	12.0%	
EBITDA	3,000,000	3,622,500	4,384,250	5,018,888	5,498,955	5,683,924	
Other Expenses							
Depreciation and Amortization Expense	(150,000)	(172,500)	(198,375)	(218,213)	(229,124)	(235,998)	
Interest Expense	(121,000)	(117,000)	(113,000)	(117,000)	(125,000)	(130,000)	
	(271,000)	(289,500)	(311,375)	(335,213)	(354,124)	(366,998)	
Pre-Tax Net Income	2,729,000	3,333,000	4,052,875	4,683,675	5,144,831	5,297,926	
Income Taxes (35%)	(955,150)	(1,166,550)	(1,418,506)	(1,639,288)	(1,800,891)	(1,854,274)	
After-Tax Net Income	1,773,850	2,166,450	2,634,369	3,044,389	3,344,140	3,443,652	
Adjustments to Determine Cash Flow							
Depreciation and Amortization	150,000	172,500	198,375	218,213	229,124	235,998	
Capital Expenditures	(172,500)	(198,375)	(228,131)	(240,034)	(240,580)	(243,078)	
Change in Non-Cash, Non-Debt Working Capital	(200,000)	(450,000)	(517,500)	(396,750)	(218,213)	(137,473)	
Change in Debt	(100,000)	(140,000)	(88,000)	317,400	174,570	109,979	
Net Cash Flow to Equity	1,451,350	1,550,575	2,001,113	2,943,218	3,289,041	3,409,078	
x Present value factor @ 23.00%	0.9017	0.7331	0.5960	0.4845	0.3939	0.3203	
Months for PV factor	6.0	18.0	30.0	42.0	54.0	66.0	
Years for PV factor	0.500	1.500	2.500	3.500	4.500	5.500	
Present Value Net Cash Flows	\$ 1,308,682	\$ 1,136,727	\$ 1,192,663	\$ 1,425,989	\$ 1,295,553	\$ 1,091,928	
Summary							
Sum of PV Net Cash Flows		\$ 7,451,542					
Plus: Residual Value		5,623,428					
Indicated Value of Equity		\$ 13,074,970					
Indicated Value of Equity (Rounded)		\$ 13,100,000					
Residual Value							
Year 6 Cash Flow		\$ 3,409,078					
x Growth Factor		1.03					
Available Cash Flow		3,511,360					
x Residual Multiple		5.0000					
		17,556,752					
x PV Factor		0.3203					
= Residual Value		\$ 5,623,428					
Net Working Capital Analysis							
Projected NWC as a % of Revenues		10.0%					
Required NWC	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
	\$ 2,800,000	\$ 3,000,000	\$ 3,450,000	\$ 3,967,500	\$ 4,384,250	\$ 4,582,463	\$ 4,719,936
Change in Net Working Capital	\$ (200,000)	\$ (450,000)	\$ (517,500)	\$ (396,750)	\$ (218,213)	\$ (137,473)	

In the illustration, the company's current working capital level is \$2,800,000 (shown as Year 0 in the Net Working Capital Analysis). Let's assume that the current level of working capital of \$2,800,000 is the net working capital target in the purchase agreement. Now, let's assume that at closing, the company does not actually deliver \$2,800,000 of working capital to the buyer. Rather, let's assume that between the time the working capital target was set and the closing date, net working capital declined to \$2,200,000. Let's see what happens to the business value:

Discounted Cash Flow Method Example							
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	
Growth Rate		15.0%	15.0%	10.0%	5.0%	3.0%	
Revenues	\$ 30,000,000	\$ 34,500,000	\$ 39,875,000	\$ 43,642,500	\$ 45,824,625	\$ 47,199,364	
EBITDA Margin	10.0%	10.5%	11.0%	11.5%	12.0%	12.0%	
EBITDA	3,000,000	3,622,500	4,384,250	5,018,888	5,498,955	5,663,924	
Other Expenses							
Depreciation and Amortization Expense	(150,000)	(172,500)	(198,375)	(218,213)	(229,124)	(236,998)	
Interest Expense	(121,000)	(117,000)	(113,000)	(117,000)	(125,000)	(130,000)	
	(271,000)	(289,500)	(311,375)	(335,213)	(354,124)	(366,998)	
Pre-Tax Net Income	2,729,000	3,333,000	4,052,875	4,683,675	5,144,831	5,297,926	
Income Taxes (35%)	(955,150)	(1,166,550)	(1,418,506)	(1,639,288)	(1,800,691)	(1,854,274)	
After-Tax Net Income	1,773,850	2,166,450	2,634,369	3,044,389	3,344,140	3,443,652	
Adjustments to Determine Cash Flow							
Depreciation and Amortization	150,000	172,500	198,375	218,213	229,124	236,998	
Capital Expenditures	(172,500)	(198,375)	(228,131)	(240,034)	(240,580)	(243,078)	
Change in Non-Cash, Non-Debt Working Capital	(800,000)	(450,000)	(517,500)	(396,750)	(218,213)	(137,473)	
Change in Debt	(100,000)	(140,000)	(86,000)	317,400	174,570	109,979	
Net Cash Flow to Equity	851,350	1,550,575	2,001,113	2,943,218	3,289,041	3,409,078	
x Present value factor @ 23.00%	0.9017	0.7331	0.5960	0.4845	0.3939	0.3203	
Months for PV factor	6.0	18.0	30.0	42.0	54.0	66.0	
Years for PV factor	0.500	1.500	2.500	3.500	4.500	5.500	
Present Value Net Cash Flows	\$ 767,662	\$ 1,136,727	\$ 1,192,663	\$ 1,425,989	\$ 1,295,553	\$ 1,091,928	
Summary							
Sum of PV Net Cash Flows	\$	6,910,522					
Plus: Residual Value						5,623,428	
Indicated Value of Equity	\$	12,533,950					
Indicated Value of Equity (Rounded)	\$	12,500,000					
Residual Value							
Year 6 Cash Flow	\$					3,409,078	
x Growth Factor						1.03	
Available Cash Flow						3,511,350	
x Residual Multiple						5.0000	
						17,556,752	
x PV Factor						0.3203	
= Residual Value	\$	5,623,428					
Net Working Capital Analysis							
Projected NWC as a % of Revenues						10.0%	
Required NWC	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
	\$ 2,200,000	\$ 3,000,000	\$ 3,450,000	\$ 3,967,500	\$ 4,384,250	\$ 4,582,463	\$ 4,719,936
Change in Net Working Capital	\$	(800,000)	(450,000)	(517,500)	(396,750)	(218,213)	(137,473)

As you can see, the value of the business dropped from \$13.1 million to \$12.5 million. If the net working capital target was in fact set at \$2,800,000, a \$600,000 reduction in purchase price would have been made for the net working capital shortfall in relation to the target, which would offset the \$600,000 decline

in value. This shows the impact that a company's working capital balance can have on its value and the ultimate purchase price.

The illustration assumes a shortfall in working capital. In certain circumstances, however, a company may have excess working capital as of the valuation date, which could lead to an adjustment to its value. One approach to determine whether an adjustment to value for excess working capital is appropriate is to examine the company's historical working capital levels. If a company has had net working capital levels of approximately 12% of sales over the past 5 years, it can be reasonably estimated that the company will continue to require that level of working capital to support future sales. Therefore, it may be appropriate to add any working capital amount in excess of 12% of sales as of the valuation date to the determined company value as excess working capital (essentially a non-operating asset). This would be similar to a purchase price being adjusted upward for the excess net working capital above the target amount defined in a purchase agreement.

As with many valuation topics, there is no cookie cutter answer for how to deal with working capital. The important thing to remember is that net working capital balances need to be considered in any transaction and that delivering a company without sufficient net working capital will only lower its value. A transaction can be structured in a number of different ways that may result in a buyer assuming all or none of the net working capital of the acquired business, but sellers need to be cognizant that this will impact the purchase price. At the end of the day, though, the seller should ultimately end up with the same value, whether that value is comprised entirely of cash or a mix of cash and retained assets.

Closing Thoughts and Coming Attractions

The process of valuing a closely-held business is a complex exercise. This process can become even more complex when you have two parties, the buyer and the seller, with opposing interests and biases. As you can see, even if the issue of purchase price and valuation were simple, there are other factors such as deal structure, earnouts and other factors that create added complexity in an Mergers and Acquisitions deals. This e-book illustrates just a few of the challenges that buyers and sellers need to navigate when trying to consummate a deal. While most Mergers and Acquisitions negotiations are grounded in fundamental economics, consideration of the specific perspectives and motivations of the buyers and sellers are paramount to the success of any ownership transaction. We are hopeful that this e-book provides some insight into some of the issues faced by buyers, sellers, and their advisors.

Stay tuned for our next e-book where we will dive deeper into some more technical accounting and valuation issues that businesses face in the Mergers and Acquisitions context. We will discuss the treatment of intangibles commonly recorded in acquisitions (e.g. customer relationships, trademarks, non-compete agreements), goodwill treatment, issues specific to stock-for-stock deals, factors impacting post-transaction profitability, and tax considerations for structuring transactions involving flow-through entities (e.g. S Corporations, Partnerships).

All examples included in this e-book have been simplified for presentation purposes. The facts and circumstances of each valuation need to be considered in developing any valuation analysis and resultant schedules may differ from those shown in this document.

About the Authors

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Dan is a Principal in Skoda Minotti's Valuation and Litigation Advisory Support group. He has 15 years of accounting and finance experience in business valuation, litigation support, financial reporting, and external and internal auditing. He has assisted a diverse client base in the areas of financial reporting valuation issues, domestic disputes, litigation matters, shareholder disputes, and estate and gift tax filing. Additionally, he has an extensive background in auditing financial statements of large, publicly traded companies and executing internal control compliance work under the Sarbanes-Oxley Act and SSAE 16 (formerly SAS 70). Dan has performed internal audits for financial, operational, and compliance purposes for public companies in both the financial services and manufacturing industries. He recently served as the corporate controller of a \$20 million annual revenue equipment leasing business, where he was responsible for all finance functions, including accounting, budgeting, forecasting, and treasury management.



Dan earned the Accredited in Business Valuation (ABV) and Certified Financial Forensics (CFF) designations, both from the American Institute of Certified Public Accountants. He has also earned the Certified Valuation Analyst (CVA) credential from the National Association of Certified Valuators and Analysts (CVA). Dan serves on the board and finance committee of the National MS Society – Ohio Buckeye Chapter.

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Sean is a Partner with Skoda Minotti's Business Valuation and Litigation Advisory Support group. In this role, he is responsible for developing and issuing valuation reports, calculation of value reports, and expert reports under valuation and consulting standards. Sean has assisted a diverse client base in litigated matters, domestic disputes, shareholder disputes, estate and gift tax filing, and financial reporting valuation issues.

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Sean earned his Master of Business Administration with honors from Case Western Reserve University and his Bachelor of Business Administration with honors from the University of Notre Dame. He is a member of the American Institute and Ohio Society of Certified Public Accountants, the National Association of Certified Valuators and Analysts, and the Center for Principled Family Advocacy. Sean serves as Chair of the Marketing Committee on the Lake Catholic High School Advisory Board. He is also a member of the AICPA's ABV Exam Review Task Force and NACVA's Case Study Peer Review Team and Q&A Review Team.

