Western Mass Venture Forum NEWS

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May 21 - 5:30 PM. . .

War Stories From The Funding Front
Berkshire Publishing Group

Moderator Tom Pratt, CPA, of Burkhart & Pizzanelli, will turn the WMVF spotlight to real experience and history in raising money for companies. Beside 60 second pitch investment opportunities and your questions, you'll see:

Stories From The Funding Front

John Hodgman, former President & CEO of MTDC returns to the Forum to share the insights of his 15 year experience leading MTDC's team to a national reputation as one of the most successful state-backed venture capital firms. John managed investments in over 110 early-stage technology companies. He remains active on the business funding front as a Director of the Massachusetts Certified Development Corporation, an organization providing asset-based financing through the SBA 504 Program.

Before joining MTDC, John was an operating executive. He was President and CEO of Stewart Systems, a computer software company; CEO of the Massachusetts Division of Employment and Training; and Director of Personnel Management for the New England Group of PricewaterhouseCoopers, LLP.

The heads of three companies will add local perspective. John Gannon, CASTion's CEO will describe how he went from presenting his plan at the Forum to closing a $2,450,000 investment. Paul Silva, ZFORM's President will describe the doors a Forum presentation opened for his operation. John Reed from BioShelters will discuss how a Forum presentation put him in contact with help and resources.

Berkshire Publishing World Class Books For A Global Market

Karen Christenson, CEO of Berkshire Publishing Group, LLC in Great Barrington will present their business plan for an initial $500,000 to expand this up and running world-class reference work writer. Berkshire products result from contributions by over 800 university level expert authors worldwide and are on the shelves of world-class university libraries.

Berkshire has been in the reference work writing business since 1995. Their works have won a number of awards and two of their recent encyclopedias are slated for nomination for the Dartmouth Prize, the most prestigious award for reference publishing by the American Library Association.

The plan is designed to implement a strategy for Berkshire's accelerated growth including the growing electronic reference work market. Having grown from sales of $250,000 in 1999 to a projected $1,000,000 in 2002 under contract, Berkshire plans to take the company to sales of over $11,000,000 by 2006 with a total $1,000,000 investment in two phases.

The panel reviewing the Berkshire plan will include John Hodgman, Christine Turner, UMASS Librarian & Project Manager and Joseph Steig, former CFO at Hot Roof.

Valuing Business Interests

Paul Peter Nicolai
Nicolai Law Group, P.C.

When it comes to valuing a closely held business, you won't find what you need to know in the financial pages. Its much more difficult than valuing a publicly held company, where you just have to look in the newspaper to see the market's perception of a publicly traded company's value.

Establishing the value of a closely held business is a very different process. Although financial statements are available, they are often not audited. Owners of closely held businesses often have goals other than maximizing company income; like maximizing personal income. There is no published list of actual transactions, and buyers and sellers of closely held businesses are not likely to discuss the details.

This article explains the basic concepts used to value closely held businesses and discounts relating to minority ownership interests. It should give you a working knowledge of the valuation process and enough background to work with an expert to prepare a valuation.

A Starting Point

IRS Revenue Ruling 59-60 gives an overview of the factors and methods used to value closely held corporate stock for estate and gift purposes. Three points made in the Ruling are especially helpful:

- In valuing the stock of corporations where market quotes are not available, all available financial facts, and all applicable factors affecting the fair market value must be considered. No general formula applies to valuing the stock.

- There will be differences of opinion on fair market value. Valuation is not a science. A sound valuation is based on all relevant facts, but common sense, informed judgment and reasonableness must guide weighing the facts and determining their significance.

- Fair market value is the price at which property would change hands between a willing buyer and seller, when the buyer is not under any compulsion to buy and the seller is not under any compulsion to sell, with both parties having reasonable knowledge of relevant facts. The hypothetical buyer is assumed to be able and willing to trade and well informed about the property and the market for it. Value is always set as of a specific date.

Valuation Methods

There are three general ways to value closely held entities - industry methods; balance sheet methods; and income statement methods. There are different types of valuations in those systems. Part of the job is to review the circumstances and decide which is the best method. Two or more methods may be used to set value, but ultimately one is picked as the most appropriate.

The Industry Method

Various industries often use a rule of thumb to set value, like a multiple of earnings or sales. This method is usually not the primary method for closely held businesses. It can serve as a final reality check, but because each business is unique, a rule of thumb will probably not set the right value.

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Valuing Business Interests - continued

Balance Sheet Methods

There are three types of balance sheet methods: (1) Book value; (2) Tangible value and (3) Adjusted book value.

For example, the balance sheet shows a net worth (total assets minus total liabilities) of $1,000,000. However, included on the balance sheet are patent rights valued at $100,000 and an office building with a depreciated cost of $50,000, currently worth $400,000 on the market. Using these facts (1) the book value is $1 million; (2) the tangible value is $900,000 ($1,000,000 - $100,000); and (3) the adjusted book value is $1,350,000 ($1,000,000 + $350,000, which is the fair market value [$400,000] in excess of book value [$50,000] of the office building).

These three methods produce values ranging from $900,000 to $1,350,000 for the same company. You must decide if in fact a balance sheet method is appropriate, and, if so, which of these three methods is best under the specific circumstances.

Balance sheet methods are generally used to set a company's liquidation value. They are not given as much weight to set the going concern value of a profitable business. The valuation methods that best reflect the value of an ongoing business are based on past and projected earnings.

Income Statement Methods

Income statement methods use past financial performance or future projections of financial operations. Two of the more widely used income statement methods are capitalization of earnings and discounted cash flow.

Capitalization of Earnings

This method analyzes, adjusts, and weighs last year's earnings to project the expected earnings of the company. The adjusted earnings are then divided by an appropriate capitalization rate ("cap rate") to arrive at the value of the business. The cap rate is set using many factors including the nature of the business, longevity, risks involved, consistency of earnings, quality of management, competition, general economic conditions, etc.

The cap rate represents the percentage rate of return a purchaser wants to earn based on its expected current cash flow. The lower the cap rate, the greater the company's value. This reflects the market reality that the greater the risk, the greater the return should be.

For example, analyzing the earnings of two companies in the same line of business shows the expected earnings of each will be $250,000. The first company has been in business for 30 years, has consistently been the industry leader, and has steady growth in earnings, customer base, and employee stability. The second company has only been in business for five years, has fluctuating earnings, and is gaining new customers a little faster than it loses old ones.

A valuation of these companies would probably conclude that the first company is worth more than the second because an investment in it has less risk. The cap rate for the first company might be 20%. The cap rate for the second might be 30%. Using these cap rates, the value of the first company is $1,250,000 ($250,000 ÷ .20) and the value of the second is $833,000 ($250,000 ÷ .30).

Discounted Cash Flow Method

This method projects future cash flow for a five to ten year period with a hypothetical sale at the end of that period, which is then discounted back to a present value using a discount factor. The higher the discount factor, (the rate of return the purchaser wants to earn from projected cash flow distributions from the purchase of the company), the less value the company has. Once again, the higher the risk, the higher the required return.

For example, a company is projected to earn $200,000, $225,000, $250,000, $275,000, and $300,000 each year over the next five years. An expert has also projected that the company could be sold for $1,200,000 at the end of that period. If the discount factor is 20%, the company is worth $1,203,029. If the discount factor is 30%, the company is worth $901,053.

Many elements go into setting the discount factor. The key factors are returns available from other investment opportunities, the nature of the specific business, risk, and confidence (or lack of confidence) in the projected cash flow stream. An investor can get a risk-free rate by buying U.S. Treasuries or Bonds. An investor can invest in the stock market and realistically expect earning a rate of 12%, which is the approximate average rate of return over the last 20 years. These investments are converted to cash very easily and the price can be set with a telephone call to a securities broker. Depending on the type of business, it is not unusual for discount rates to be in the upper teens, and return rates up to the mid-to-upper thirties.

Adjustments

The projections must include adjustments to account for differences between the way the business is operated now and how it might be operated by a willing buyer. For example, if the owner is taking out a $200,000 salary, but the market salary for someone performing that job is only $125,000, the valuator would reduce expenses by $75,000 for this difference. Other adjustments should be made for family members being paid, rent to owners, owners' expenses, and so on. This also applies to computing historical cash flow under the capitalization of earnings method.

Other factors can affect the value of a company including the amount of current assets, liabilities, and the type of entity it is. If two companies are identical except that one has $1,000,000 more cash and accounts receivable than the other, the company with more cash is worth more than the other.

There are other methods to value businesses based on earnings that may be appropriate under certain circumstances.

Discount Factors

What if you're valuing less than the whole company? Discounts require an analysis of the specific facts and circumstances about each business and the ownership interest.

Lack of Control

The majority shareholder, co-tenant, or general partner of the business generally has control over decisions affecting the business including major capital spending and the distributions of profits. An investor holding a minority stock, tenancy, or limited partnership interest has little or no control over the business. In some cases a minority owner or limited partner can only veto a major decision.

A buyer of a minority interest who does not have control needs a greater rate of return than one who has control. The buyer of a minority interest is taking a greater risk. They cannot make decisions an owner might make. A non-controlling interest in a closely held company is very illiquid. If the buyer cannot control cash distributions, there is less chance of getting them. As these uncertainties pile up, the need for a higher return increases. This reduces the value a willing buyer would pay for a non controlling interest.

There is a correlation between the increased rate of return and a discount off a value based on the type of control. Once you pinpoint the type of control, you can assign a proper percentage discount off full value which increases the rate of return. A review of the entity's charter documents will show the type of control a partial buyer would have. Control generally falls into one of four categories: (1) Absolute control; (2) Absolute veto; (3) Partial veto or (4) Marginal or no control

Once you identify what kind of control the interest carries, a weighted discount factor is applied to each level of control to set the required increase in the rate of return. An interest with absolute control requires no discount because there is no lack of control. An ownership interest with marginal or no control for all types of control would result in the highest discount off full value. Each situation is different. It is not unusual for limitations in control to justify discounts of 20% or more.

Lack of Investment Market & Liquidity

Minority and limited partnership interests are difficult to sell for many good reasons. This makes them illiquid. A discount is required to compensate for this lack of liquidity. One factor investors consider is the historical and projected cash distributions generated from an investment. An entity which has not distributed cash, or a small or less certain stream of cash, would require a greater discount than an entity with a history of large cash distributions and a reasonable expectation of a meaningful cash flow in the near future. The timing, receipt, and likelihood of cash distributions an investor expects to get drives the required rate of return. The longer an investor has to wait for the return, the higher the rate of return which is required, reducing value.

There are many other factors that can affect the value of an interest in a closely held company not discussed here.

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