VALUE BRIDGE: UNDERSTANDING THE PAST AND PLANNING FOR THE FUTURE

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There are many situations in which a private company needs an independent business valuation. Often, a business valuation is a one-time event, like during an acquisition or a buyout. There are also occasions when business owners are best served by annual business valuations.

Annual valuations most commonly occur in family-owned businesses that are professionally managed. Annual valuations help both family members and managers track the value of the business over time, allowing for course corrections and assisting in the formulation of a sound strategy.

Owners or managers that choose annual valuations will see fluctuations in the value of the company. These differences occur in all businesses, but they are more visible during an independent valuation process.

Adams Capital can provide a Value Bridge to explain the value difference in detail, including which factors influenced the increase or decrease in value.

The Value Bridge is especially helpful in explaining value changes from year-to-year for employee equity compensation.

A VALUE BRIDGE EXPLAINS CHANGES IN A BUSINESS' VALUE

A Value Bridge explains key factors influencing valuation. You may be familiar with money management firm reports that show gains or losses in a portfolio from one year to the next (e.g., equities are up, bonds are down, withdrawals, etc.).

Changes in business value are due to a wide variety of factors, some within the control of management and some due to external market forces. By highlighting the relative impact of different factors, the Value Bridge provides a clear answer to the question, "Why did the value of my business change?" or even better, "What changed the value of my business?" Once you know you can take action.

In addition to answering what changed, a Value Bridge can assist management in explaining changes in value to the board of directors, executive team, or other stakeholders. The Value Bridge is especially helpful in explaining value changes from year-to-year for employee equity compensation.

FACTORS THAT INFLUENCE BUSINESS VALUE

The Value Bridge incorporates many factors that influence value, and those values depend on the particular valuation project. Some factors consistently included are: the passage of time (the change in present value factors resulting from different valuation dates), market multiples, market interest rates, changes in financial projections, and changes in the company specific risk premium. Some of these are influenced by owners, management, and employee actions. Others are external forces beyond management control.

Some asset-based industries, like banking and real estate, may use balance sheet multiples.

VALUATION FACTORS OUTSIDE COMPANY CONTROL: MARKET RULES

The passage of time: As the name implies, the value of a business will always be affected by the passage of time. Over time a healthy business will grow, and higher financial projections become closer to the valuation date as time passes.

Market multiples: Investors compare public share price to metrics like revenue or EBITDA (earnings before interest, taxes, depreciation, and amortization). Some asset-based industries, like banking and real estate, may use balance sheet multiples. A clear shift in the multiples for guideline companies indicates the appropriate valuation multiple for the subject company may have also changed.

Interest rates: Changes in interest rates from one valuation to the next will influence business value, primarily through the cost of capital. Increasing interest rates will typically negatively impact business value with a higher required return for all stakeholders. Higher interest rates also mean that business loans are more expensive, diverting limited cash to interest payments rather than growth-oriented investment.

VALUATION FACTORS BOTH OUTSIDE AND WITHIN COMPANY CONTROL

Change in projections: Any change in future performance expectations will impact business value. If a company realizes higher-than-expected growth and increases their future performance expectations, that will increase the value of the business. Changes in financial projections can be due to both market factors, such as the change in macroeconomic conditions or industry trends, as well as specific management actions which benefit or impair the company.

For example, the COVID-19 pandemic resulted in dramatically increased financial projections for home fitness equipment manufacturers, although this was completely out of their control. However, there are also specific growth strategies implemented by management which are successful and result in higher financial projections. It is generally impossible to completely separate which portion of forecast changes are solely related to macro trends or specific management strategies. Changes in financial projections are at least partially dependent on management's policies, strategy, and business plan execution as well as the overall economic and industry environment.

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VALUATION FACTORS WITHIN COMPANY CONTROL: COMPANY RULES

Company Specific Risk: By definition, company specific risk is specific to the subject company and generally within control of management and stakeholders. These unique risks can be limited and dissipate over time while other risks are persistent. A persistent risk may be related to dependence on a single customer, single supplier, or a key person.

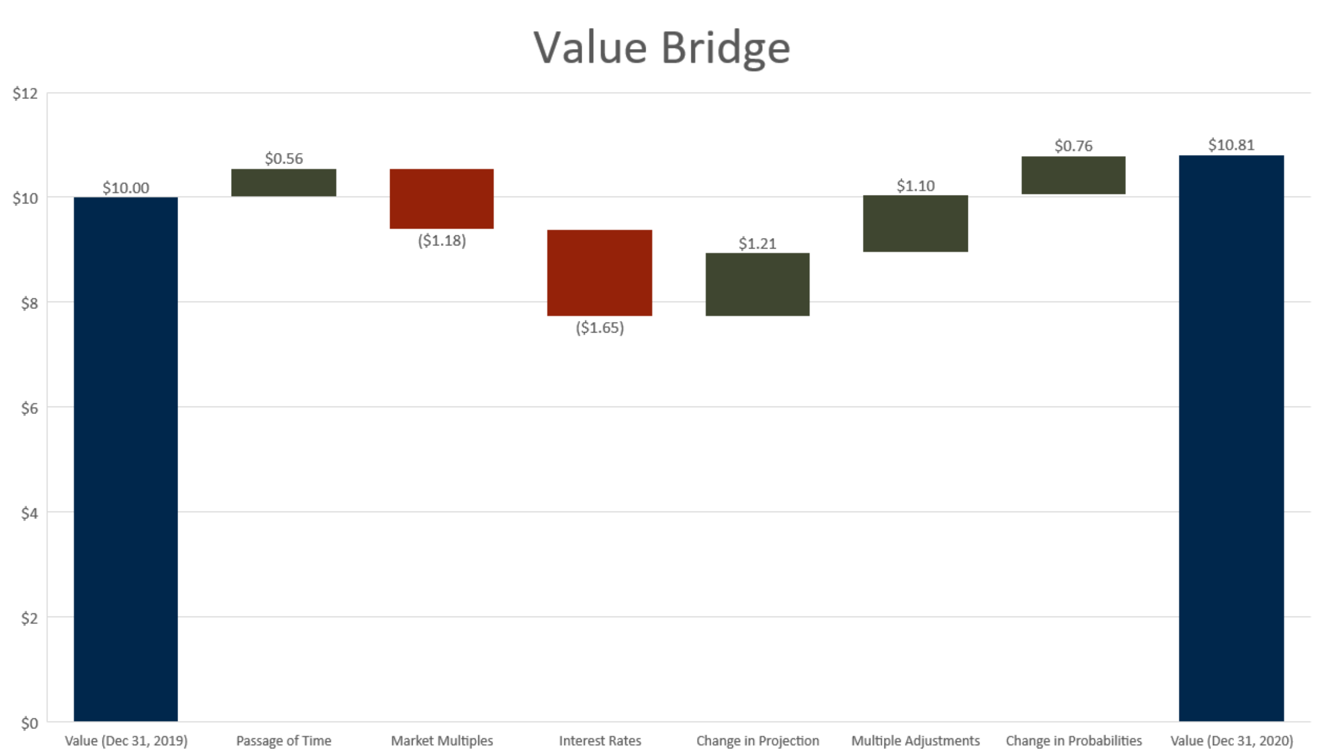
Illustrated below are a **multiple adjustment** and a **change in probabilities** adjustment. We may adjust the multiple selection based on an understanding of company risks. Sometimes there may be a base case and an exceptional case and a probability of achieving each. These probabilities may change from year to year.

Key-person risk is a common adjustment. Risk is increased when someone is vital to success and is difficult to replace. If this person is unable to work, the company can suffer. If this person competes, the company will suffer more. Most family-owned businesses have a key-person risk.

We may apply a risk adjustment if a company has significant debt that they might not be able to refinance under the same terms. This situation came up frequently during the COVID-19 pandemic, when many business owners needed to refinance but were unable to qualify during shutdowns and periods of low revenue.

These risk factors can often be mitigated over time. For example, has the company expanded its executive management team to reduce key-person dependency, improved geographic diversification, or taken measures to mitigate regulatory risks that previously threatened the company? These are factors that can improve value and are solely related to proactive steps taken by management.

Company specific adjustments can be tied to goals and objectives providing a connection between action and performance.



A VALUE BRIDGE LEADS TO MEANINGFUL DIALOGUE

A Value Bridge shines a light on factors that are important to management and shareholders. This perspective helps align expectations for management, employees, and board members. The Value Bridge shows that the value change can be due exclusively to factors outside of management's control, like interest rates and market multiples. If management performed well, despite the difficult circumstances, they should be praised and rewarded for their hard work and smart strategy, not punished for factors beyond their control.

If we ask a line employee how to improve overall company profitability, they may have some ideas but lack the ability to implement. If instead that employee's compensation is tied to how many orders they can process in a shift, we find employees competing to be the best. And if a portion of their compensation is tied to daily team production, employees have a vested interest in hiring, training, and retaining talented workers. How much management do teams like this really need? We recently toured a facility where a big screen in the warehouse showed each worker's order fulfilment. When all the orders were packed the workers went home. Everybody was pitching in to help the last guy finish up!

It is important to create effective incentives for management teams and employees. A business can gain a competitive advantage by retaining good leaders and rewarding employees for the factors that are within their control, rather than punishing them for factors they cannot control.

If a management team was able to take decisive action and save a business from greater loss, even in the face of negative external factors, they might still deserve a bonus, even if cash flow circumstances necessitate those bonuses be deferred.

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OBJECTIVE ANALYSIS

Any business theoretically could measure value internally. Very large businesses have resources to conduct valuation measurements internally; however, those results are perceived as biased. Some larger private businesses have the capability but not the capacity to conduct valuation, and most private businesses do not have the internal capacity. Any internal valuation often faces bias suspicion.

For example, if a CFO performs a valuation and finds that management's actions deserve a large bonus, that could be met with skepticism. If a neutral third party comes to this same conclusion, it is easier for all parties to work toward understanding and consensus.

SUMMARY

A Value Bridge connects the dots between valuation conclusions for a company as of two different dates. It is most commonly used for annual valuation updates. The Value Bridge analysis frequently shows multiple factors counteracting or mitigating the impact of others. There are almost always a mix of positive factors and negative factors which together have a net impact on the conclusion, which is either higher or lower than the previous value conclusion.

There is also a spectrum of control over the value drivers ranging from market factors that are out of the hands of management to company specific risk related solely to the company and management's policies.
