

VALUATION NEWS

NEWS FROM QUIST VALUATION
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Welcome

This issue of Quist Valuation News explores the income approach and the importance of recognizing the effect of the sensitivity of inputs and how they can impact perceived value. The first article examines the advantages of using Monte Carlo simulation to stress test cash flows. The second article assesses rules of thumb used in selecting or relying upon transaction multiples and possible pitfalls to beware of as a result.

As always, we hope that you find value in this edition of Quist Valuation News.

Sincerely,
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Stress Testing Inputs to the Income Approach

Valuation is fraught with assumptions that are often based on limited empirical data. Uncertainty, which is generally a reflection of risk, permeates throughout the valuation process. Understanding, identifying and assessing risk is ultimately the driving factor in effective valuation assessments. While risk is a component of any valuation approach used to establish the value of a company, it is often difficult to quantify in an income based approach. At Quist, we find that the income approach is the most used methodology for assessing the value of both entities and intangible assets. In other words, value is derived based on an assessment of future returns rather than comparable transactions (a market approach) or replacement value (a cost approach).

Establishing value by employing the income approach is not without its pitfalls. Quist recognizes that the result is only as good as the inputs. When assessing an income approach, we consider three basic components: future cash flows (projections), discount rates and the terminal value. Small adjustments to the inputs in each of these can result in large swings in the resulting value.

Consider the following simplified example of cash flow discounting over a four year period:

Company A	Period	1	2	3	4	
	Cash Flow	\$100	\$120	\$150	\$150	Total
	Present Value	\$83	\$83	\$87	\$72	\$326
	Discount Rate	20%				

Company B	Period	1	2	3	4	
	Cash Flow	\$90	\$108	\$135	\$135	Total
	Present Value	\$74	\$73	\$74	\$61	\$282
	Discount Rate	22%				

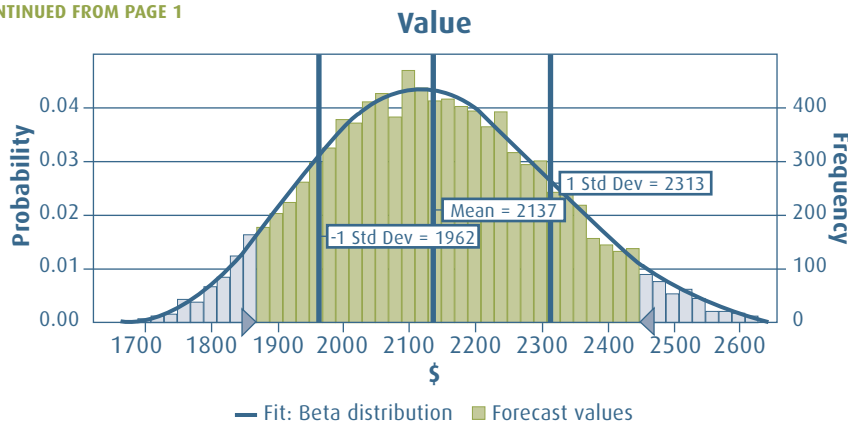
A 10% adjustment in projected cash flow combined with a 2% adjustment in the discount rate results in a 14% adjustment in value. In other words, mistakes made in estimating projected cash flow, albeit slight, are often amplified in the value differential.

Given the sensitivity of these inputs, and the unlimited combination, how can we better understand the result and improve our decision making process? A straightforward approach is to simply vary the inputs. For example, analyze different cash flow models based on a range of growth rates, margins, and discount rates. At a minimum this will help recognize the range of outputs a model can produce and the sensitivity the analysis may have to various outputs. Another method is to employ Monte Carlo simulation that varies the inputs and analyzes output results. A simulation model provides a better understanding of the variables, how changes in those variables can affect the result, and a means of stress testing the projections.

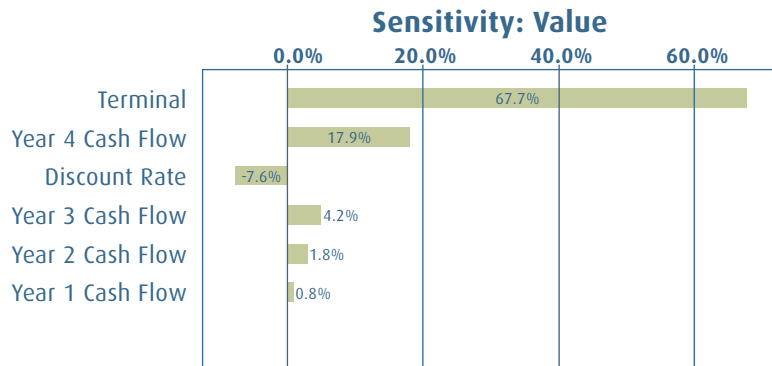
Using the same cash flow inputs and discount ranges established below we can derive a range of possible values with consideration given to the standard deviation of each critical input.

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Difference	14%
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The resulting output of a Monte Carlo simulation provides a range of value and confidence interval. In addition, a Monte Carlo simulation will identify the critical inputs that drive the valuation result. As shown in the following chart, a single input can have a significant effect on the result.



Understanding which inputs drive the ultimate result clarifies the overall assessment of risk and further explains the key valuation drivers. As shown in the above sensitivity chart, the terminal value has a significant impact in our example and a thorough assessment of its components is warranted. In other situations we may, for example, find that the revenue growth rate has the largest effect on the result. Under this circumstance additional analysis of market share, competitive landscape and the inputs used to establish the growth may be warranted. In the end, valuation results, the ultimate understanding of risk, and the defensibility of our conclusions improve by considering and understanding the sensitivity of inputs and their impact on value.

Rules of Thumb and M&A Multiples

Owners of privately-held companies periodically struggle with the seemingly simple question, “What is the value of my business?” On the surface, answers are abundant whether they follow publicly traded comparables in their market space,

a “rule of thumb” for their industry, book value, a colleague at the golf club or the latest deal in the *Wall Street Journal*; attaining information is not the problem. Understanding, recognizing and rationalizing the inputs, however, is a different story. In the end, most business owners are searching for a “benchmark”, a “place to start”, a “fair value”. Why

then, with all the available inputs, is this seemingly simple task such a struggle?

The following series of articles will examine the difficulties in attaining reasonable, defensible, and most importantly, simple valuation metrics from the marketplace. The articles will explore how these seemingly straightforward inputs lead to critical mistakes by business owners in pricing their business for either an internal sale to employees or an external sale to a third party. The first in the series focuses on multiples derived from M&A transactions (“transaction multiples”).

We often read about or hear first hand about transactions in the marketplace. For every tight lipped seller we encounter there seems to be five that are more than willing over a cocktail to tell you about the deal. Data companies follow these transactions by following SEC filings, press releases and talking with management. Each company has its own methodology for recording transaction prices as do newspaper reporters and sellers. In short, transaction data derived from the marketplace is generally not uniformly treated and analyzed.

Consider the inputs that define a transaction multiple. A multiple is based on the price paid divided by the latest available financial metric. For example, if you were to purchase a business with \$100 cash that generated revenues of \$50 in the latest twelve months, the multiple would be two times revenue (purchase price divided by the fundamental). If all deals were cash and without contingencies we could easily derive a defensible and sensible range of multiples. However,

as we all know, most deals have alternative forms of consideration and all deals have contingencies.

What would be the price paid for a business, if you put 25% down (\$25) and earned the remaining 75% based on a payout depending upon performance ("earnout") over three years? Is the multiple still two times revenue? Multiples don't discriminate. If the earnout is a slam dunk, (e.g. requiring no additional growth in a market completely protected from downside) you might consider it to have the same value as cash. If not, then what? What is the risk inherent in recognizing the earnout? Consider that if you sell to an acquirer who is planning to immediately restructure the business versus leaving management in place, the risk of realizing the earnout might in fact be greater. The opposite scenario may be true as well, especially if the new acquirer brings strategic synergistic assets to your sales force. What if the earnout has a collar protecting against downside or upside risk? What if the payments derived from the earnout are placed in the form of a note?

Risk moves between the buyer and seller as transactions are negotiated, which is especially true for non-cash deals. In the end, the multiple is heavily dependent on the deal terms and valuation metrics. So what in the end does this mean for business owners? Quite simply it means that if you are going to rely on a multiple to establish the value of your business it is important to flush out the facts first. If the common talk in your industry is a multiple of revenue, be certain that you understand how deals are being priced. In addition, you must recognize that every transaction is unique and

variable depending on a multitude of factors.

The difficulties of transaction multiples are apparent from the marketplace. They can provide a simple, efficient solution to a complex problem; however, and yes there is always a however, they can be costly in the long-run. Transaction multiples can lead business owners to overprice their shares for internal and/or external transactions. Worst of all they create expectations that are unfounded in finance. Value is based on future expectancy, which in the end is cash flows, cash flows, cash flows.

Stay tuned for the second problem with transaction multiples...Revenues, EBITDA, cash flow, book value...What makes sense and why.



Hot Valuation Issues

- October 4, 2005 – The IRS issued the proposed regulations under Section 409A for the treatment of nonqualified deferred compensation plans. The proposed regulations push back the original date for adopting conforming amendments to these plans from December 31, 2005 to December 31, 2006. According to Section 409A, any stock option with an exercise price below the fair market value of the underlying stock as of the option grant date constitutes deferred compensation. The result is significant federal tax consequences for the option recipient including a 20% additional tax. "The Treasury Department and the IRS remain concerned that manipulation of the characteristics of the underlying stock may lead to abuses with respect to stock options and stock appreciation rights (IRS 26 CFR Part 1)." However,

several conditions must still be met prior to December 31, 2005 to ensure that stiff penalties be avoided. Quist Valuation has extensive expertise in establishing the fair market value of common stock as it relates to equity compensation plans. Please stay tuned for more valuation insight into this pressing issue and feel free to contact Quist for additional information.

- FASB and IASB are moving closer to common standards in the accounting treatment for business combinations and non-controlling interests. Each published an Exposure Draft that would replace FASB's Statement No. 141 and IASB's IFRS 3. The Exposure Drafts expand the principle of fair value for measuring the acquired assets and assumed liabilities in a business combination. A significant departure outlined in the Exposure Drafts is the proposed treatment of contingent consideration. The current practice requires recognizing only when they are probable and can be readily measured. The acquiring entity would instead, under the Exposure Drafts, measure the contingent considerations under the fair value standard at the time of acquisition. Subsequent changes in the fair value of the consideration would not affect the measurement of the purchase price or goodwill on the acquisition date as is the case under FAS 141. Other changes include accounting for business acquisition costs, further clarification on the valuation hierarchy and additional guidance on step and partial acquisitions. The comment period for both Exposure Drafts closed on October 28, 2005. In their current form, the Exposure Drafts continue the push towards fair value accounting and the continued convergence between IFRS and US GAAP.



VALUATION NEWS

In this issue:

- Testing the Inputs
- Rules of Thumb and M&A Multiples
- Market Spotlight – Registered Investment Advisors

Market Spotlight: Registered Investment Advisors (RIAs)

Earlier this year, Quist Valuation was chosen by Charles Schwab to be their exclusive business valuation resource for the Schwab Advisor Transition Support program. As a result, Brett Suchor, President of Quist Valuation, spoke at a six city workshop series designed to provide Schwab affiliated RIAs with the knowledge and tools necessary to effectively evaluate mergers, acquisitions and internal succession issues. The sold-out workshops were held in New York, Chicago, San Francisco, Los Angeles, Atlanta and Las Vegas. RIAs present a host of interesting valuation circumstances, including personal goodwill and transferability of customer relationships. Quist has developed significant expertise in this thriving industry in recent years. Please do not hesitate to contact Quist if you are an RIA or have a client that is one and wrestling with a valuation issue.

NEWS IN BRIEF

- “Fair Warning,” an article that examines the current conflict-of-interest controversy surrounding the use of fairness opinions in M&A transactions, written by Brett Suchor, president of Quist Valuation and Hendrik Jordaan, attorney with Holme Roberts & Owen LLP, appears in the October 24, 2005 print and digital versions of *The Deal*. If you are not a subscriber to *The Deal* and would like a reprint of this article, please contact Quist Valuation.

IN OUR NEXT ISSUE:

- 123R – Binomial Lattice Model Insights
- Rules of Thumb and Transaction Multiples Part II
- Discounting Your Latest Round of Preferred Stock and How It Relates to 409A