CPA Ireland Skillnet

CPA Ireland Skillnet, is a training network that is funded by Skillnets, a state funded, enterprise led support body dedicated to the promotion and facilitation of training and up-skilling as key elements in sustaining Ireland's national competitiveness.
The CPA Ireland Skillnet provides excellent value CPE (continual Professional Education) in accountancy, law, tax and strategic personal development to accountants working both in practice and in industry. However our attendees are not limited to the accountancy field as we welcome all interested parties to our events.

The CPA Ireland Skillnet is funded by member companies and the Training Networks Programme, an initiative of Skillnets Ltd. funded from the Department of Education and Skills.

www.skillnets.ie

Trainee Accountant Workshop Series

December 19th 2016

P1 – Current Issues in Managerial Finance (Valuation)

Presented By:
Dr Garvan Whelan CPA

BACKGROUND

- **SKILLNET**
  - State funded, enterprise led support body dedicated to the promotion and facilitation of training and **up-skilling** as key elements in sustaining Ireland's national competitiveness.
- **Managerial Finance**
  - Develop students' knowledge and **skills**
  - Present quantitative and qualitative information for **management decision making** integrating analysis, argument, and commentary.

BACKGROUND

- **OBJECTIVE** (Dr G Whelan CPA)
  - Help practitioners and their clients to make better business decisions through financial information analysis and **management skills development** workshops.
- **INFORMATION SOURCES**
  - IFAC (International Federation of Accountants); Coyne (2012); Survey of CPA practitioners at 'Practice Matters' Conferences (September 2016).

SKILLS AND THE ACCOUNTANT (IFAC 2011)

Valuation of SMEs

Learning Objective

To improve your understanding of the **current issues** in relation to:

- The importance of SME valuations
- A critical examination of the various valuation techniques
- Applying this knowledge to advise clients helping them to add value.

Importance of SME Valuations

Transaction Related
- Private financing
- IPOs
- Acquisitions
- Bankruptcy
- Compensation

Compliance Related
- Financial reporting
- Tax reporting

Litigation Related
- Damages
- Lost profits
- Shareholder disputes

SME v Large/Public Firm Valuation

Private Firms	Public Firms
Less mature	Later in life cycle
Smaller size → ↑ risk → ↑ risk premiums	Larger and have access to public financing
Managers often have substantial ownership position	Greater external shareholder ownership
Potentially ↓ quality and depth of management	Greater quality and depth of management

SME v Large/Public Firm Valuation

Private Firms	Public Firms
Lower quality of information disclosure → ↑ risk and ↓ valuations	↑ pressure to make timely, detailed disclosures
Shareholders have a longer-term perspective	More emphasis on short-term performance
Greater emphasis on tax management	Less emphasis on tax management

Factors to Be Considered in SME Valuation

- Nature and History of Business
- General and Specific Economic Outlook
- Book Value and Financial Condition of the Business
- Earning Capacity of the Company
- Dividend-Paying Capacity of the Company
- Goodwill or Other Intangible Value
- Market Price of Similar Publically-Traded Securities
- Marketability of the Securities
- Control Premium

The Valuation Process

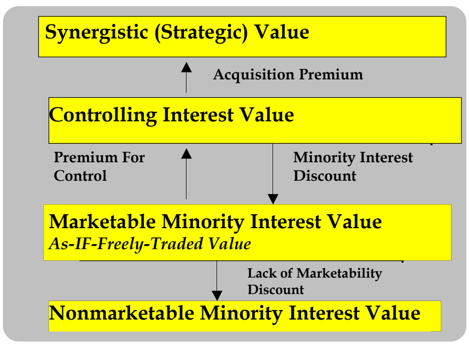
Phase I

•Perform Due Diligence (tour facilities, interview management, etc…)
•Completion of the valuation questionnaire
•Meet with relevant parties
•Provide preliminary value

Phase II

•Update value prior to transaction
• Complete fully documented valuation report

Levels of Relative Value



SME Valuation Approaches

'Income' Approach	• Based on the present value of expected future cash flows or income
Market Approach	• Based on pricing multiples from sales of similar companies
Asset-Based Approach	• Based on the value of the company's net assets (assets minus liabilities)

Income Approach

- **Discounted Net Cash Flow Method (Debt-Free)**
  - The determination of the appropriate net cash flows to discount, based upon projected income statements and balance sheets for the subject company;
  - The selection of an appropriate discount rate for the subject company projections, based upon an analysis of alternative investments, including the cost of capital for guideline public companies;
  - The determination of a terminal value for the subject company, as of the end of the last period for which projections are available

14

Earnings Normalization

Reported earnings + **Adjustments** (for nonrecurring, noneconomic, unusual items) = **Normalized earnings** (earnings capacity of the business if it is run efficiently)

Example: Earnings Normalization

Example	Adjustment to Income Statement
Private firm CEO is paid $1,200,000. Analyst estimates market rate for CEO is $800,000.	Reduce SG&A expenses by $400,000.
Firm leases a warehouse for $200,000/year from a family member. Analyst estimates market rate is $300,000.	Increase SG&A expenses by $100,000.
Firm owns a vacant building that has reported expenses of $90,000 and depreciation expenses of $15,000. The building is noncore.	Reduce SG&A expenses by $90,000. Reduce depreciation expenses by $15,000.
Firm may be acquired by a strategic Buyer A that expects synergies with cost savings of $230,000. Buyer B is a financial buyer.	Reduce SG&A expenses by $230,000 when calculating normalized earnings for Buyer A, but not for Buyer B.

Market Approach: Three Methods

Guideline Public Company
- Based on the observed multiples of comparable companies

Guideline Transactions
- Based on pricing multiples from the sale of entire companies

Prior Transaction Method
- Based on actual transactions in the stock of the private company

Market Approach

Guideline Public Company
- Based on the observed multiples of comparable companies

Guideline Transactions
- Based on pricing multiples from the sale of entire companies

Prior Transaction Method
- Based on actual transactions in the stock of the private company

Guideline Public Company Method

- Identify group of comparable public companies
- Derive pricing multiples for the guideline companies
- Adjust pricing multiples for relative risk and growth prospects

Guideline Transactions Method

Most relevant for valuing the controlling interest in a private company

Transaction data based on public filings by parties to the transaction or from certain transaction databases

Factors to consider in assessing pricing multiples:

- Synergies
- Contingent consideration
- Noncash consideration
- Availability of transactions
- Changes between transaction and valuation dates

Prior Transaction Method

Underlying Principle

- Based on actual transactions in the stock of the subject company
- Based on either the actual price paid or the multiples implied from the transaction
- Most relevant when valuing the minority equity interest of a company

Advantages

- Provides the most meaningful evidence of value since it based on actual transactions in the company's stock

Disadvantages

- It can be a less reliable method if transactions are infrequent

Market Approach
– Guideline Company Method

Practical Considerations

- **Develop appropriate "comparable" criteria**
  - Industry characteristics
  - Size of companies
  - Trading activity of the stock
  - Availability of information
  - Financial trends: profitability, growth, etc…
  - Financial analysis: ratio comparisons

22

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Market Approach
Guideline Company Method
- Practical Considerations

- Perform comparative risk analysis between guideline companies and subject company
- Develop Risk Adjusted Valuation Multiples (Debt-Free)
  - Price to Earnings (P/E)
  - Price to Revenues (P/R)
  - Price to Book Value (P/BV)
  - Price to Assets (P/A) etc.
- Determine the value of the subject company's market value of total invested capital ("TIC")

23

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Market Approach
– Transaction Method
Practical Considerations

Transactions are normally of 100% control purchases and some may represent "strategic" buyers

Multiples of EBIT, EBITDA and Revenues are used if available

Transaction terms (financing, contingent payouts, etc..) need to be well understood if transaction multiples are to be used as a valuation method. Otherwise they may be useful as a sanity check.

24

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Asset-Based Approach

- Adjusted Book Value Method ("ABV"). Assets and liabilities are restated to market values. May require machinery & equipment and/or other asset and liability appraisals.
- Market Value of net assets will represent 100% of the subject company's equity value
- Typically not a suitable method for valuing going concern operating companies (method does not provide values for goodwill and other intangible assets)
- The ABV Method is typically applied in cases involving a liquidation analysis, or in cases where the subject company has a heavy investment in tangible assets, such as property development companies.
- Also used as baseline valuations for worse case scenarios.

25

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Conclusion

- "Strategic analysis does not stop at the point of often vague and woolly **qualitative** analysis, it goes on to a second phase of valuation of the strategies and **quantitative** […] analysis" (Arnold 2005: 119).
- **Thank you** for your time
- Welcome **questions and feedback**

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