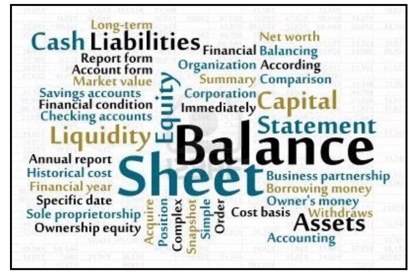
Business Transaction Marketplace

Information about Business Valuations, M&A and Corporate Finance September 2013

Acquistion Balance Sheet – Where Deal Structuring Takes Place

How a business transaction is *priced*, differs from how it is *structured*.

Business transactions are priced from the income statement
Business transactions are structured from the balance sheet



Let's begin with *pricing*. The common pricing formula is:

$$EV = E \times M$$

Earnings (E) is often represented by earnings before interest, taxes, depreciation and amortization (EBITDA), derived from the income statement (adjusted for discretionary and non-recurring items). EBITDA is the operating cash flows which must satisfy the buyer's four claimholders to cash flows: 1) investors (ROI), 2) lenders (P&I), 3) company (W/C and CapEx), and 4) Uncle Sam (taxes).

To what degree a buyer is willing to pay to receive the seller's future operating cash flows is represented by a market multiple (M) – which again, largely depends upon satisfying the buyer's claimholders to cash flows. The Enterprise Value (EV) the buyer receives is essentially the *operating assets* of the business. What specific operating assets being purchased depends upon how the transaction is *structured* – the subject matter of this article.

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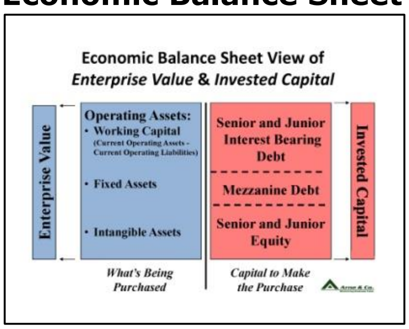
Economic Balance Sheet



When a buyer pays a certain multiple for the right to receive future operating cash flows (e.g. EBITDA), the resulting Enterprise Value (EV) is comprised of three (3) classes of operating assets:

- Working Capital
- Fixed Assets
- Intangible Assets

Let's examine each of these asset classes for structuring issues.

Structuring Working Capital

The most challenging aspect in structuring a transaction surrounds Working Capital. One reason – it's always changing. From a business transaction standpoint, Working Capital only considers current operating assets less current operating liabilities. In a business transaction, it's those: a) assets and liabilities needed to produce operating cash flows, and b) those assets with that are converted to cash within one year, and those operating liabilities extinguished within one year.

Structuring Issues

- Define what working capital accounts are included. For example, cash, accounts receivable, inventory, prepaid expenses, accounts payable.
  - From a current liability standpoint, the position often taken is that there should be a corresponding current asset purchased. For example: accounts payable with inventory, deferred revenue with accounts receivable, customer deposits and cash.

Structuring Working Capital (cont)

- Define how much working capital is needed (i.e. Benchmark or Target Working Capital)
  - Methods to determine the amount of needed working capital include: a) monthly averages of working capital accounts, b) industry ratios, c) projected financial statements, and d) the Bardahl Method (see article).
- Other Working Capital structuring issues that may arise:
  - The stated level of inventory has historically been understated, or has been reinstated in one period. How will this effect operating cash flows and the pricing of the business?
  - The composition of the defined working capital accounts changes from what was originally defined, to what exists at closing; particularly if the buyer's source of debt capital is based upon differing advance rates against current operating assets (e.g. accounts receivable vs. inventory).
  - The seller has accounts receivable that are beyond what a buyer's lender will finance. Should those receivables be excluded from working capital? If not purchased, structure a payment to the seller when the buyer collects?
  - The seller has excess inventory that is beyond what the business requires and buyer is willing to purchase. Should this inventory be excluded from working capital? If not purchased, structure a payment to the seller when the buyer sells (similar to consigned inventory)?
  - Buyer assumes the seller's accrued salaries and accrued vacation to accommodate the transitioning process. Define as part of what constitutes working capital? Treat as a non-operating liabilities and an additional payment to the seller (and no adjustment of the transaction price)?
  - Buyer assumes the seller's unearned revenue and customer deposits. Require seller to leave equal amount of cash behind? Treat as non-operating liabilities and additional payments to the seller?

Structuring Fixed Assets

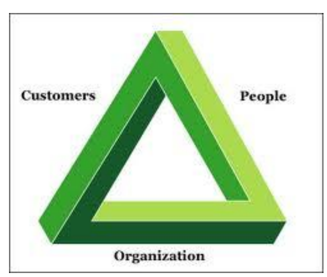
Again, fixed assets should be operating; those tangible assets (excluding inventory) that are necessary in the production of operating cash flows. This category includes: a) real estate, b) leasehold improvements, c) machinery and equipment, d) vehicles, e) office furniture and equipment, f) etc.

<u>Structuring Issues</u>

- Treating the real estate owned by the business as a non-operating asset or an operating asset.
  - If treated as a non-operating fixed asset, remove building depreciation, and substitute a fair market triple net rent as part of operating cash flows. Value the business and real estate separately (different risk profiles). Real estate may or may not be purchased by the buyer.
  - If treated as an operating fixed asset, then the real estate is considered purchased. When valued together, the risk profiles are combined – the business portion and the real estate portion.
- Other Fixed Assets structuring issues that may arise:
  - Seller has made significant investment in fixed assets before they've had an effect on producing operating cash flows. Maybe an earnout is a solution? (see article)
  - Seller has excess non-operating fixed assets (e.g. personal auto). Generally, seller retains.
  - Seller's fixed assets are in need of repair or are deficient to maintain operating cash flows. Buyer will often negotiate a price reduction.

Structuring Intangible Assets

In a business transaction, intangible assets are those "residual assets" remaining after subtracting working capital and fixed assets from the transaction price.



<u>Structuring Issues</u>

- Define who owns the goodwill. Is it business goodwill or personal goodwill? (see article)
- Define how non-compete, consulting and employment agreements are treated:
  - Included as part of the transaction price and part of the intangible assets that produce the operating cash flows?
  - Not included as part of the transaction price and additional compensation to the seller?
- Define how payments under an earn-out are to be treated: a) additional intangible asset (transaction price)? or, b) earned income (to the selling individual)?