Arne & Co.

Business Transaction Marketplace

Information about Business Valuations, Acquisitions, & Sales **June 2008**

Value vs. Price – Part I

In the March 2008 Issue of *Business Transaction Marketplace*SM, we discussed some of the biggest errors management makes involving M&A. The #1 error – "price paid was too high". Fundamental in every business transaction is what the business is worth. However, "value" is not the same as "price". The adage is:

"You determine *value* and negotiate *price*".

Here are two points to remember about value:

#1. The value of a business enterprise lies in its FUTURE. Historical financial results only reflect the past.
#2. Arriving at the value for a business enterprise requires assessing the RISKS associated with the business achieving future operating cash flows.

In Part I of this two-Part discussion, we begin by describing what's meant by value; then, describe the process of determining the value of a business enterprise.

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What is *Fair Market Value*?

Before starting an engagement, every business appraiser needs to define the assignment. What should be defined is specifically described in an article (click here), aptly subtitled: "The Meeting of the Minds at the Start of a Business Valuation".

One of the elements that needs to be defined in a business valuation assignment is the standard of value that the business appraiser will be following. In order to distinguish value from price, let's examine the most common standard of value – *fair market value* (*FMV*) – the definition of which is as follows:

> *The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell, and when both have reasonable knowledge of the relevant facts.*

So by definition, when a business appraiser takes on an assignment to determine the *FMV* of a business enterprise, he or she must do so under these assumptions:

- The consideration passed between the buyer and the seller is a cash equivalent
- Buyer and seller are hypothetical
- Buyer and seller are willing and able to consummate the transaction
- Buyer and seller are acting at arms length
- The market for buyers and sellers is open and unrestricted
- Neither the buyer nor the seller is under any compulsion to consummate the transaction
- Both buyer and seller have knowledge surrounding the relevant facts of the transaction

In Part II of this discussion, we will examine each of these points in the "real world" of how businesses are bought and sold. That is, the factors that come into play when price is negotiated.

How is *Fair Market Value* Determined and for What Purposes?

At Arne & Co., the *FMV* of a business enterprise is determined by following a Business Valuation Process (click here), the main tasks being as follows:

- Perform an internal analysis and risk assessment
- Perform an external analysis and risk assessment
- Make historical financial statement adjustments and/or obtain financial projections
- Apply valuation approaches and methods
- Arrive at a valuation conclusion

Generally, there are four (4) purposes for determining the *FMV* of a business enterprise:

1. Planning: internal use by owners and management
2. Taxation: external use by the IRS for estate, gift and income tax compliance requirements
3. Disputes: external use by the Courts; internal use in a mediation or settlement facilitation
4. Transactions: internal or external by buyers or capital providers; sellers and capital users

In the September 2008 issue of *Business Transaction Marketplace*SM, we will present Part II on this topic, and describe how buyers can price a business to help insure that the don't over pay.

Marketplace Alert

As we approach the November Presidential elections, here are the tax plans for the leading Republican and Democratic candidates. Source: *The Kiplinger Tax Letter*

McCain's Tax Plan

Personal Income Tax:

McCain would double the personal exemption to $7,000, cutting millions from the tax rolls. He would also repeal the AMT for individuals. McCain's plan maintains the Bush tax cuts for all taxpayers, including high incomers by keeping the maximum35% marginal income tax rate, the 15% top rate on dividends and long-term gains, and the $1,000 child credit and marriage penalty relief.

Corporate Income Tax:

He would cut the top corporate tax rate from 35% to 15%.

Obama's Tax Plan

Personal Income Tax:

A credit of up to $500 per person or $1,000 per family to offset payroll tax on the first $8,100 of earned income. Seniors with incomes below $50,000 would be exempt from income tax. Non-itemizers would get a 10% mortgage interest credit.

Higher-income taxpayers would pay the previous top marginal tax rate of 39.6%. The 15% top rate on capital gains would rise to 20% or more, and dividends would be taxed as ordinary income.

Corporate Income Tax:

Corporations also stand to pay higher taxes under Obama's plan. He wants to eliminate tax "loopholes" for large oil and gas companies, crack down on offshore tax havens, and tighten worker classification rules. But small firms would get some tax relief, including a 0% rate on capital gains for start-up businesses.

This announcement appears
as a matter of record only

Kinetico Quality Water Systems of Central New Mexico Albuquerque, New Mexico

Has sold substantially all of its assets to

TLC Company, Inc.
Albuquerque, New Mexico

The undersigned assisted in the negotiations and acted as advisor to Kinetico Quality Water Systems of Central New Mexico

Arne & Co.

Business Transaction Marketplace

Information about Business Valuations, Acquisitions, & Sales **September 2008**

Value vs. Price – Part II

In the June 2008 Issue of *Business Transaction Marketplace*SM, we presented Part I of this discussion on Value vs. Price. To review, the #1 error made by management involving a merger or acquisition is the "Price paid was too high".

In Part I we discussed Value, where we defined *fair market value (FMV)*, listed the assumptions inherent in that definition (see later section), and described how *FMV* is determined and for what purposes.

So what is Price? Webster would define Price as *the amount of money needed to purchase something*. In the context of a business transaction, a term closely related to Price is *investment value* – defined as: *the value to a particular investor based on individual requirements and expectations.*

In this issue, we'll now discuss Price, and the factors that come into play when Price is negotiated.

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Qualitative Factors That Impact Price

The definition of Price above refers to a "particular" investor (buyer), just as there will be a particular seller. The real world of business transactions involves people. People with deeply held values, differing backgrounds and knowledge, and who are emotional - just by being human. That's why people are so often unpredictable.

So when buyers and sellers look at a business to be bought and sold, the Price they see will be influenced by there their particular motivations, perceptions of risk and growth of the business, and their overall knowledge of the process. Price is also affected by how it's negotiated (see later section). The adage is:

"You determine Value and negotiate Price".

Quantitative Factors That Impact Price

The test for possible overpayment begins with an analysis of the operating cash flows of the business. EBITDA (earnings before interest, taxes, depreciation and amortization) is often the cash flow measurement from which pricing decisions are made.

If a buyer and a seller can agree that the business produces a certain level of EBITDA, then the Price can be tested to see if satisfies the buyer's post-transaction claimholders to EBITDA.

Those four claimholders are:

1. Uncle Sam: The state and federal income taxes on entity profits
2. Lenders: The principal and interest repayment on acquisition loans
3. Investors: The return on and of the cash equity the buyer puts in to make the acquisition
4. Company: The working capital and capital expenditures needed for future growth

If the buyer's claimholders to cash flows are not met, then the Price may be too high and/or terms too stringent. The reverse is true as well. If after meeting the buyer's claimholders' to cash flows, there are excess post-transaction cash flows remaining, then the Price may be too low, and/or the terms are too lenient. Therefore, not giving what the seller wants – the highest Price and best terms.

Ultimately, the objective is to demonstrate that the pricing and deal structure satisfies the buyer's post-transaction claimholders to cash flows, while also satisfying the seller's expectation of receiving the highest Price and best terms.

A Win-Win Method in Negotitating Price

In the well know bestseller on negotiation – *"Getting to YES"* – the authors suggest this four-step negotiation methodology:

Step 1 – Separate the PEOPLE from the problem
Step 2 – Focus on INTERESTS, not positions
Step 3 – Invent OPTIONS for mutual gain
Step 4 – Insist on using objective CRITERIA

Ideally, the goal is to negotiate a Price that's a *Win-Win* for both the buyer and seller; and, leads to a *wise agreement*, which the authors define as: *one which meets the legitimate interests of each side to the extent possible, resolves conflicting interests fairly, is durable, and takes community interests into account*.

Comparing Value and Price

Value: The consideration passed between the buyer and the seller is a cash equivalent
Price: The consideration could be cash and many other forms of consideration

Value: Buyer and seller are hypothetical
Price: Buyer and seller are particular business entities, investors, and owners

Value: Buyer and seller are willing and able to consummate the transaction
Price: A seller may be forced to sell because of an involuntary event

Value: Buyer and seller are acting at arms length
Price: Buyer and seller could be related in some way

Value: The market for buyers and sellers is open and unrestricted
Price: The seller could be restricted by agreement with other owners or with third parties

Value: Neither the buyer nor the seller is under any compulsion to consummate the transaction
Price: Buyer and seller must be motivated by something – otherwise a transaction would never occur

Value: Both buyer and seller have knowledge surrounding the relevant facts of the transaction
Price: Buyers and sellers will often have differing levels of knowledge surrounding the business transaction

Marketplace Alert

The Small Business Administration (SBA), through the 7(a) program, provides loan guarantees of up to $1.5 million, which borrowers obtain through participating lenders. Effective August 1, 2008, the SBA issued new rules that will affect business transactions. The new rules now require an independent business valuation for loans greater than $350,000. The business appraiser – termed a "qualified source" – must be an individual who regularly receives compensation for business valuations, and is accredited by a recognized organization.

Upcoming Darrell Arne Seminars

Enterprise Valuation
Sponsored by: Technology Ventures Corporation
September 24, 2008 – Intel Site Innovation Center; Rio Rancho, NM
September 25, 2008 – Santa Fe Business Incubator; Santa Fe, NM

October 16, 2008 – *Tax Boot Camp for the M&A Professional*
Sponsored by: Pennsylvania Business Brokers Association; Denver, PA

November 17, 2008 – *Maximizing the Value of a Privately Held Company*
November 18, 2008 – *Advanced M&A Tax Strategies and Deal Structures* –
Sponsored by: International Business Brokers Association; Louisville, KY