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Business Valuation Builds Shareholder Value

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Building shareholder value has become an important topic in today's economy, especially with respect to professional service firms. The reason is that more and more people are looking to invest where they work – where they can impact the value of their investment. Recent studies indicate that privately held firms have held their value better over the recent term than their publicly traded counterparts. But building shareholder value does not just happen. In fact, most managers, and even some owners, are unaware of how to impact value outside of the company profits and book value. Both management and ownership need to understand that value is much more than what is on the financial statements – they need to understand all the factors and risks that determine value.

And one of the best ways to identify the elements that factor in to the value of your design firm is through an appraisal or business valuation. An independent valuation will give you so much more than just the number a firm is worth. It is a comprehensive management tool that acts as a firm-wide audit. As a result of the guidelines set forth in Internal Revenue Code Section 59-60 for business valuations, an appraiser must consider multiple factors in reaching a conclusion of value. These factors go well beyond just analyzing the financial make-up of

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the company. Following is a partial summary of the key elements an appraiser must consider in reaching a conclusion of value.

Financial – This involves an in-depth analysis of the profit and loss (income) statements and balance sheets for a number of years, including year-to-date periods. As part of this analysis, the appraiser will determine what the key indicators (value drivers) are for your firm and look at the trends of these indicators. For a design firm, there are three different classes of value drivers. The first is your performance ratios: growth in net service revenue (gross revenue less subconsultant, reimbursable and other direct expenses aside from direct labor); earnings before interest, taxes, depreciation and amortization as a percent of net service revenue; chargeability; net labor multiplier; revenue factor or net payroll multiplier; and overhead rate.

The second is your liquidity metrics, including the current ratio, quick ratio and average collection period.

And the third is your leverage ratios, illustrated by your total liabilities-to-equity and interest-bearing debt-to-equity. In addition, as part of this step, the appraiser will perform a benchmark study of your firm's common-size ratios and key indicators as they compare against other firms in the design industry as closely related to your firm as possible – size, location, service area, etc.

Management – Through due diligence, interviews and meetings, the appraiser will assess the strengths and weaknesses of the management team. They will look at the overall leadership depth within the firm, key risks associated with management, the business acumen of the managers and the track record of management to develop, implement and execute strategic plans.

Ownership – The appraiser will review the corporate governance and shareholder documents. They will be in a position to identify the strengths and weaknesses of these documents, as they pertain to share-

holder value. For example, “Is there a ‘put option’ within the shareholder’s agreement?” or “Over how long a period of time can a stock buy-back occur?” are just two of the many paragraphs in this document that can impact firm value. Furthermore, the appraiser will review the feasibility of the firm’s current ownership transition or succession plan.

Competition – This step involves taking a closer look at who your firm goes up against day-in and day-out with respect to winning new jobs. The appraiser creates a level of understanding with respect to your most frequently encountered competitors, as well as some research into the competitive marketplace in your geographic and service area regions.

Industry and Economy – The appraiser will research the national, regional and local economies and the impact these may have on your company. In addition, they will conduct industry research, reviewing current trends and looking at prepared forecasts to determine any changes that may affect the future for your firm.

Sales and Marketing – Weight will be given to how the firm wins work, the effectiveness of its marketing and business development efforts and the overall marketing plan. The appraiser will also look at the breakdown of revenue based on geographic location, client allocation and service area distribution.

Capital Investments – This includes comparing your firm’s capital expenditures with that of similar firms in the design industry to determine if you are “under-” or “over-” investing in your business. This involves looking at your property, plant and equipment, technology and other capital assets that are used in the derivation of revenue. The appraiser will look at some additional financial ratios, such as return on equity, return on assets and return on investments to

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create a better level of understanding of how this element impacts value. In addition, they will note the financial reporting and accounting software, as well as other software used to manage and conduct the business.

Personnel – The appraiser will weigh if your company is investing in its staff. This means identifying future leaders and devel-

oping their skills and abilities through education and mentoring programs. In addition, they will review turnover rates and how easy or difficult it is to hire necessary and/or key staff and designers.

These eight elements will be the major focus of the appraiser and through the valuation process, issues can be uncovered and challenges identified prior to them being re-

flected in the company's value. Thus, the valuation engagement will provide you with much more than just a number – it will provide you with an overall audit of your firm.

In today's economy, it is smarter to invest in yourself and your company, so start now with a business valuation and really learn what your business is worth and how to increase shareholder value. ■

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