



Providing comprehensive investment banking services to privately held companies

Valuation Methodology

The question most frequently asked Alpha Omega Capital Partners (AOCP) is “What is the value of my business and how is it determined?”

In this edition, we will explore definitions for value, EBITDA and SDE, the financial factors that affect value, methodologies for determining value, valuation preparation, valuation multiples, how you can estimate your company’s value, and why equity values will vary by method.

Definitions To Remember:

- **Market Value** is defined by the IRS as the amount at which a company would change hands between a willing buyer and a willing seller when neither is acting under compulsion and when both have knowledge of the relevant facts.
- **Investment Value** is the value of a company to a particular investor.
- **Fair Value** is a judicially determined concept used in divorces, partner buy-outs, etc. and varies widely.
- **Book Value** is simply assets minus liabilities using GAAP accounting standards.
- **Liquidation Value** is the proceeds from quick & orderly liquidation of assets.
- **Enterprise Value** is the market value of the business including debt.

- **Transaction Value** is the Enterprise value less debt or net proceeds from the deal before taxes and fees.

When advising clients, AOCP defines value as the present value of all future income streams in today’s market.

- **EBITDA** means earnings before interest, taxes, depreciation, and amortization.
- **SDE** means seller discretionary earnings and equals the total of EBITDA plus seller compensation after replacement value, and nonrecurring one-time expenses. Because the owners of privately held companies typically target a zero tax strategy, SDE attempts to recapture the earnings that would be available to shareholders after the payment of industry competitive compensation to management.
- **M&A** means mergers and acquisitions.
- **Discount Factors** are tangible and intangible conditions that exist in a company that reduce its value below the theoretical Market Value of the same company if those conditions did not exist. In



FAST FACTS

U.S. Businesses

- 90 percent are family owned.
- 40 percent are facing ownership transfer.
- A large % fail after the founder leaves.

Succession Issues

- Who will participate & who will watch
- Conditions of participation
- Leadership preparation
- Letting go
- Liquidity – funding retirement & estate taxes
- Cornucopia kids – bridging generational values
- Attracting & retaining non-family managers
- Compensation – equity versus merit
- Successors – who chooses and how to choose

SOURCE: U.S. SMALL BUSINESS ADMINISTRATION

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other words, those shortcomings in your business that increase the risk to the buyer and cause him to lower his estimate of value. To maximize value, buyer risk must be minimized. Discount Factors include but are not limited to the following:

The Big Four

Business Size

Industry Type

Revenue Trends (Top Line Growth)

Profitability Trends (Bottom Line)

Organizational Factors

Depth and Breadth of Management

Importance Of Key Personnel

Organizational Structure/policies

Age Of Workforce

Operational Factors

Geographic Location

Facilities And Equipment Age

Quality Of Operations/systems

Regulatory Compliance

Financial Factors

Reliability Of Financial Statements

Lending Environment

Capital Deficiencies

Product And Marketing Factors

Barriers To Entry And Life Of Patents

Company Or Product Life Cycle

Diversification Of Customer Base

Misc. Factors

Legal Structure

Stability Of The Industry

Buyer Type And Terms Of Sale

Market (Enterprise) Value is determined by taking a weighted average of M&A industry accepted calculation methods taking into consideration the strength of a company's balance sheet, selling prices for comparable companies, growth in total revenues and earnings, and discount factors:

Valuation Methods Used By AOCP:

- Book Value (Balance Sheet Method) — Used To Determine Adjusted Going Concern Value
- DCF — Discounting Future Earnings With and Without Growth (Discount Factors Used in Calculation)
- Industry Sale Comparables
- Multiples of Cash Flow
- Multiples of Revenue (Cap of Earnings)
- Partner Experience — Integration of Experience and Judgment (Discount Factors Considered).

The valuation analyst starts by conducting research to obtain market and transaction information to determine market comparables. By obtaining and analyzing the historic financial records of the client company, the analyst can then determine EBITDA and then adjust for owner's compensation, perks, and non-recurring items to determine SDE. After all of the calculations are completed, a strong dose of common sense, experience & judgment are then added to the analysis to obtain the estimated market value of the company for the three buyer types: for a private (job seeking) buyer, for a private equity fund (PEG) buyer, and for a strategic buyer (a direct or indirect competitor).

Buyer Types Affect Value:

As noted above, there are three distinct buyer types with subsets

of each. Although these buyer types share the profit objective, their tactics in obtaining profit vary greatly. We sometimes refer to Private Buyers as "job seekers" and they are often "refugees of corporate America". Although there are a large number of private buyers in the market place, they face the highest personal level of risk when initiating a transaction and therefore offer the lowest prices. PEGs are fewer in number and are strategically focused which further reduces the number that may pursue a specific project. They formulate their offers based nearly 100% on the potential of the acquisition to meet the return objectives of their investors. Strategic buyers are typically the least price sensitive because they are most likely to profit from economies of scale and consolidation. At AOCP, we calculate market value three ways:

1. Private Buyer (lowest)
2. Private Equity Group (middle to high)
3. Strategic Buyer (highest)

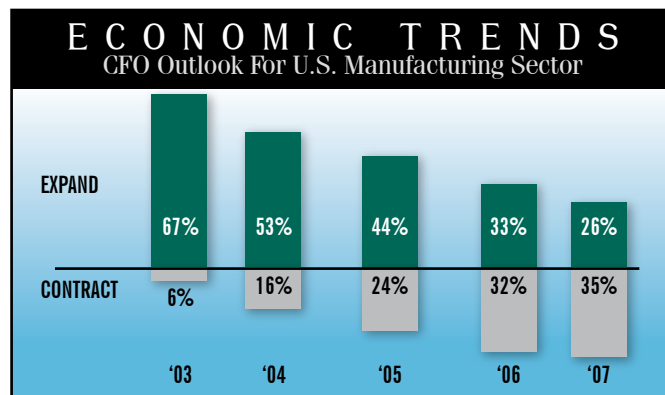
Why leave money on the table by selling to the wrong buyer?

Company Size Affects Value:

Larger companies command higher multiples. Large strategic buyers and PEGs realize that the transaction and management costs are similar for both small and medium sized companies resulting in a lower return on their time for smaller companies. Seldom will strategic or PEG buyers consider companies with revenues less than \$10 million unless the acquisition target can be quickly and easily consolidated into an existing, larger business that they already own. This fact often times leaves the owners of small businesses with a singular option: private buyers. We want to emphasize that there is always a direct correlation between company size and value.

Industry Type Affects Value:

Your industry type will “significantly” affect both the value and the selling terms of your business. In addition to the generic issues that buyers will consider such as investment required, special knowledge required, professional licenses, and the general business model, you must also analyze the effect that industry conditions will have on your transaction. What are the trends in your industry? Are competitors or customers moving offshore? Are customers consolidating? Are large corporations moving into your space?



SOURCE: CFO MAGAZINE

FIGURE 1: SDE MULTIPLES

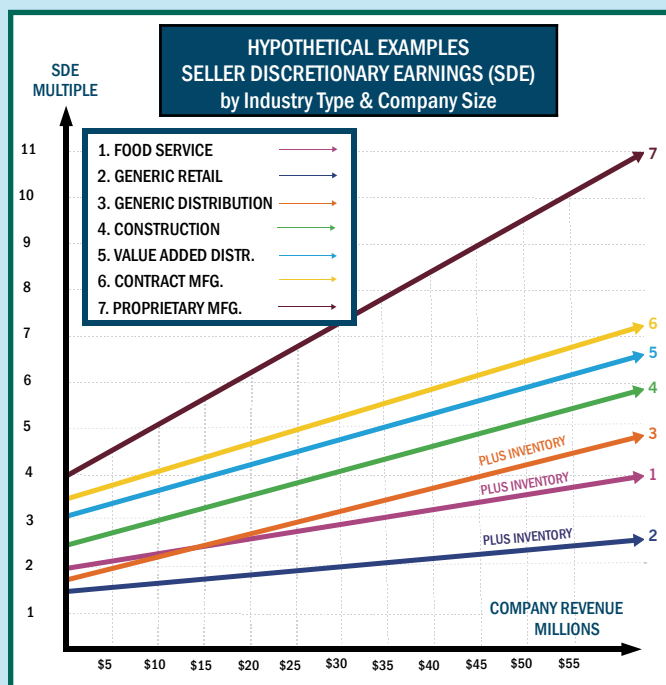


FIGURE 2: % OF REVENUES MULTIPLES

Industry Type	Value As Percentage of Revenues
Food Service • Independents • Franchises	35% to 50% (low end) (high end)
Generic Retail (Increases with revenues)	30% to 35%
Generic Distribution (Increases with revenues)	30% to 50%
Value Added Distribution (Increases with revenues)	40% to 60%
Construction • General Contracting • Specialty Trades	20% 30%
Contract Manufacturing (Increases with revenues)	60% to 80%
Proprietary Manufacturing (Increases with revenues)	80% to 110%

Estimate Your Own Company's Value

Multiple of SDE Method

Earnings Before Taxes	\$
+ Interest Expense	\$
+ Depreciation	\$
Total EBITDA	\$
One Time Expenses	\$
Owner's Compensation	\$
Total SDE	\$

SDE Multiplier

Refer To Fig. 1 To Determine The SDE Multiple For Your Industry

Enterprise Value	\$
Less Funded Debt	\$
Transaction Value	\$

Revenues Method

Company Sales	\$
Multiplier	
Enterprise Value	\$
Less Funded Debt	\$
Transaction Value	\$

Refer To Fig. 2 To Determine The % of Revenues Multiple For Your Industry

As always, we are here for you from Beginning to End.
804.282.7680

Business Listings

- \$ Construction Machinery & Equipment Dealer
Annual Revenues \$44,000,000
Adj. EBITDA \$1,700,000
- \$ Independent Distributor to the Mining Industry
Annual Revenues \$19,100,000
Adj. EBITDA \$1,200,000
- \$ Blank Video, Data, and Disc Media Distributor
Annual Revenues \$13,100,000
Adj. EBITDA \$1,400,000
- \$ Logistics Transportation Operation
(Moving & Final Mile Delivery Service)
Annual Revenues \$9,440,000
Adj. EBITDA \$403,000
- \$ Design-Build, Commercial & Industrial
General Contractor
Annual Revenues \$6,800,000
Adj. EBITDA \$630,000
- \$ Home and Hearth Products Distributor
Annual Revenues \$6,300,000
Adj. EBITDA \$690,000
- \$ Medical Device Manufacturer
Annual Revenues \$5,100,000
Adj. EBITDA \$1,000,000
- \$ Ticket & Tour Operator
Annual Revenues \$3,900,000
Adj. EBITDA \$287,000
- \$ Value Added Distributor to the Coal Mining Industry
Annual Revenues \$3,100,000
Adj. EBITDA \$415,000
- \$ Mechanical Contractor (HVAC & Electrical)
Annual Revenues \$2,800,000
Adj. EBITDA \$213,500
- \$ Online Retailer, U.S. Produced Japanese Anime Products
Annual Revenues \$2,650,000
Adj. EBITDA \$400,000
- \$ Specialty Manufacturer
Annual Revenues \$2,560,000
Adj. EBITDA \$600,000

Alpha Omega Capital Partners Announces Kentucky Expansion

We are pleased to announce the addition of Fred Doster to the Alpha Omega team to head our new Kentucky office. "Fred" has a strong business background that includes over 20 years of service to public and privately held manufacturing and retail companies such as Pillsbury (Division Controller), Perry Oceanographics (VP Finance), Camping World (Treasurer) and Minit Mart Foods (CFO). In these capacities, he was responsible for a variety of complex acquisition and divestiture activities.



Since 1994, Fred has worked independently as a financial consultant and investment banker for business owners, private equity funds, and individuals selling, buying and recapitalizing privately held businesses.

Fred earned Bachelor and Master of Science Degrees in Accounting from Syracuse University and University of Miami (FL), respectively. Fred resides with his wife, Jennie, in Lexington, Kentucky.

If you're interested in selling your company, please call Fred at Alpha Omega's new Lexington, Kentucky office: 859.223.8157 or send Email to fed@aocp.com.

Learn more about Alpha Omega Capital Partners at www.aocp.com



7202 Glen Forest Dr., Suite 300
Richmond, Virginia 23226

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Telephone Directory www.aocp.com

Richmond, VA Office:

- Robert Louthan804.282.7680 (307)
- Larry Miller 804.673.2589
- Robert Mitchell.....804.282.7680 (306)
- George Sydnor804.282.7680 (302)
- Anthony Vincent804.282.7680 (303)

Lexington, KY Office:

- Fred Doster.....859.223.8157

New York, NY Office:

- Paula Brancato.....212.608.2724