# Valuations Plus

## Acquisition: Major tool for increasing value

A major strategy of global companies is to build company and shareholder value through acquisition.

In fact, according to consulting firm Bain, 90 percent sustained value creators (SVCs) – companies that grow at least 5.5 percent annually while earning cost of capital – use mergers and acquisition as a primary tool to drive increased revenues and stock values.

**An acquisition can either build on existing assets or fill gaps and shore up shortfalls.**

Defining appropriate targets depends on your company growth strategy and goals. What is your long-term desired market position? Do you want to grow in products or services or enter new geographic locations or industries?

A realistic assessment of present strengths, competitive advantages and weaknesses will point to possible avenues to explore. An acquisition can either build on existing assets or fill gaps and shore up shortfalls. New technologies are often a driving force behind purchase transactions.

Strategies can be defined as scope or scale. Scope means adding to what your company offers through purchasing of related businesses. Examples include a retailer adding a complementary service business or a computer manufacturer purchasing a software company. The aim is to capture more customer dollars along the value chain. Manufacturers often purchase suppliers to ensure an ongoing source of critical materials or components.

In a scale transaction, similar businesses are purchased, for example, additional restaurants, hotels or stores. Why compete – just buy the other company. This strategy can lead to market domination in an area (buying competitors) or expanded locations (new cities or states).

The purchased businesses either retain their identity or are rebranded as company stores. Another strategy is to buy companies producing products at different price points, thereby increasing the customer base. A parent company might hold luxury, middle-of-the-road and economy brands. If handled well, the luxury brand can add luster to the less prestigious products.

Integration of scope and scale deals is different. In scale transactions, company integration can result in cost and operating efficiencies because of similarities. Merging back-office staff and transactions is a benefit. Purchasing can also be centralized. Marketing is leveraged by extended reach.

In contrast, a scope transaction can be more complex. Since the business sector, customer base and operating systems are usually different, it's critical to retain experienced personnel to shorten the parent company learning curve. There may be very little overlap in operations and management.

Each opportunity must be examined closely to determine if it is indeed a good deal for your company. Preparing a deal thesis is the first step. This study documents how the

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**Fall 2015**

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*Valuations and litigation support information from the office of:*

Kushner LaGraize, L.L.C.

CERTIFIED PUBLIC ACCOUNTANTS

3330 W. Esplanade Avenue • Suite 100 • Metairie, Louisiana 70002

(504) 838-9991 • Fax: (504) 833-7971 • www.kl-cpa.com

# How the labor market impacts sales price

When considering business value, most company owners think about their tangible assets – namely buildings, equipment, vehicles and inventory.

It's easier to attach a value based on age, condition, expected revenues and useful life. But what about intangible assets? Here, most people think about goodwill or the established reputation of the business.

An assembled work force is also an intangible asset that might not immediately come to mind. Although employees are very real in a corporeal sense, the productivity and revenue-generating value they bring to an enterprise is not always understood or assessed properly.

Some appraisers use the cost approach, namely the expenses the new business owner would incur to recruit and train the assembled work force. Input needed for this calculation includes base payroll, average salary per employee, attrition rate and percent of payroll cost to recruit and train. The attrition rate is subtracted from salaries to get the adjusted payroll. Then percentages for recruitment and training are applied to the adjusted payroll to calculate the cost.

For a $1 million payroll, this value might be about $150,000, or 15 percent. Cost of recruitment and training specific to the industry should be used. However, the economic environment and labor markets don't remain static and, in some cases, using industry standards is not adequate. Adjustments may need to be made concerning the present difficulty or ease of hiring and training.

Another method used is the income approach, which computes the present value of future earnings. This approach works well with professional services firms and other sectors where there is a direct correlation between specific employees and revenues. These firms also need to take into account retention rates and ease of employee replacement.

In the current environment, some industries might have a glut of employees while others are scrambling to locate enough workers. It all depends on the local labor force or the ability to move in new employees. Another factor is location. In areas with large layoffs, there initially may be more than enough available workers. But over time, many people move to other areas where there is employment, thus eroding the skill base.

Areas that once scrambled to attract companies might find themselves trying to bring in new workers instead. Finding skilled workers is a challenge for many companies right now.

Surveys by the National Association for Business Economics (NABE) and the National Federation of Independent Businesses (NFIB) in July 2015 both reported that companies across sectors are having difficulty locating skilled workers.

In fact, 48 percent of the small businesses participating in the July 2015 Small Business Optimism Index reported that they had few or no qualified applicants for openings. Positions lacking applicants include accounting, information technology, construction and manufacturing. The NABE predicts rising wages in the face of this continued shortage.

Some industries are also facing the impact of Baby Boomer retirements. Even though more Baby Boomers are continuing to work after the traditional retirement age, many opt out of full-time employment. This situation represents a loss of skills, productivity and experience that can impact companies until younger workers catch up. Skilled trades, management, aircraft pilots, teaching, engineering and law enforcement are occupations that are projected to have possible employee shortages.

In valuing an assembled work force, the mobility, available pool, skill and education levels required, and competition are all factors that must be evaluated. How dedicated are the present employees? If the turnover rate is historically high, then change of ownership might not remedy that. How does the company compare to peers in this regard?

That information will provide insight as to the management abilities of present ownership. If a company has highly skilled workers or key employees, what is the impact if they leave? How easy will they be to replace? A simple example is a restaurant that loses its prized chef.

A productive, trained and loyal work force is essential to a successful business, no matter how excellent the products or services offered might be. Understanding how current economy and labor force trends impact a company is essential to assigning value. ■

**Acquisitions** *continued from front*

transaction will add value to both companies. It spells out what is being purchased – physical assets, capabilities, access to markets, technologies – and the expected financial and operational results of the purchase.

Once the deal thesis is complete, thorough due diligence is performed to test assumptions, especially concerning benefits to the parent company. A rigorous examination of the target company's finances, operations, hidden liabilities, market position and image must be implemented.

Based on due diligence, the optimal purchase price can be determined. Some companies begin the due diligence process in advance of a company coming on the market. They proactively determine whether or not a business is an attractive target.

After the deal is made, the integration process must be planned thoroughly. If this critical stage doesn't go well, key personnel might leave and company morale and profitability can plummet. The difficulty of integrating operations, procedures and policies is often understated, especially in companies with complex back-end systems and differing management styles.

Another important area is change management, which helps employees cope with the merger process. There is often a great deal of fear and uncertainty. Minimizing this will help the process go smoothly. Engaging existing employees and asking them for input can help create a culture of commitment so that they work with the parent company instead of against it.

If implemented correctly, acquisition of other companies can create something truly greater than the sum of the parts. With interest rates still low and abundant capital available in the present economic environment, the time might be right to explore acquisition possibilities for your company. ■

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# When a partner leaves – Issues that affect valuation

Business partnerships have been compared to marriages – and never is that more apparent than when they come to an end. Without a solid agreement and valuation plan, the situation can get very messy.

Lacking a concrete path forward may eventually involve the courts and years of litigation as a Wisconsin company discovered. In the case of the *Estate of James H. Matteson v. Robert R. Matteson, et al.*, the partners lacked a written agreement concerning terms for parting ways. Half-brothers, the Mattesons owned a communications company that sold and serviced radios and related equipment.

James left the partnership while Robert continued to operate the company. They could not resolve a dispute over how much James was due for his share of the company. Since the matter was unresolved at James's death three years later, the estate sued for a share of the company. The Wisconsin Appellate Court ruled that James was entitled to compensation until the partnership's affairs were concluded, even though his leaving dissolved the partnership.

The court made it clear in its decision that one of three things can happen without an agreement:

1. The partners can come to terms.
2. One partner can force a windup, meaning the company is liquidated.
3. The outgoing partner can sue to force a settlement and will be entitled to a share of earnings until settlement is reached.

Obviously the costs and stress of litigation and the ill feeling accompanying such a course of action are best avoided. But, as in a marriage, new partners are often reluctant to face the fact that their union may not last. After all, successful partnerships are built upon working together for mutual success. That said, defining terms of an exit should be completed up front, including how the value of partnership shares will be determined.

Valuation methods include assessing book value, cash flows, earnings, sales, profits or capitalization of income or dividends – or a combination of methods. Sometimes a projected liquidation value is used.

Depending on the industry, some methods make more sense than others at arriving at a fair value. The method and process should be agreed upon in the partnership agreement, as well as the way a valuation professional will be selected. Often the process is approached as if the company will be sold with the resulting value assigned to the partners according to their ownership percentage.

Specific issues affecting valuation and determination of value include the following:

**Goodwill** – Is it personal or professional? In the case of partnerships offering services, such as law firms or health services, it is important to figure out if goodwill is tied to individuals or the company. If clients or patients will follow when the partner leaves, then goodwill is personal. If the reputation of the company is stronger than that of any individual partner, then goodwill is associated with the business and therefore an asset.

**Book value** – Will book values of assets be what is shown on the balance sheet – for example, cost minus depreciation – or will values be adjusted to the current market? This should be specifically stated. In many cases, book value understates the true value of the asset, for example with equipment that has been fully depreciated or real estate in a rising market.

**Transferability and repeat business** – Especially in a services business, the issue of reliability of income and repeat business comes into play. If the partner leaving brought the business to the firm and it's staying there, that affects the settlement.

**Control** – Another factor that influences value is control. If a partner has little or no control over company decisions, then that affects the value of that partner's interest. The argument can be made that if some partners don't have control of company direction, they shouldn't benefit equally from the success of those decisions. Passive members or silent partners are treated differently than active ones.

**Statement of earnings** – Most companies seek to minimize taxes, and therefore financial statements reflect aggressive income reduction tactics.

In determining net profits, are these statements to be used or are they to be recast to reflect true performance? An example is accelerated depreciation or Section 179 expensing that reduces net income significantly. In the case of a valuation, this might understate profits, cash flow and market value of assets.

**Return on investment** – Return on investment means the cash that remains after all expenses are paid and working capital and fixed assets are funded. Salary and benefits are a return on labor, not investment.

**Taxation issues** – Discrepancies between how the IRS would value an interest versus how the partnership does should be resolved. In some cases, former partners or their estates have been taxed for a higher value than they received.

In summary, business valuation methods and procedures should be an integral part of any partnership agreement. Working with professionals for periodic valuations will help partners stay abreast of what their interests are worth, allowing them to prepare should one of the partners exit. This is essential for the continued viability of the company. ■

*Kushner LaGraize, L.L.C.*

CERTIFIED PUBLIC ACCOUNTANTS

3330 W. Esplanade Avenue
Suite 100
Metairie, Louisiana 70002

# Efficient internal operations essential to profitability

Unless you are a natural administrator, you may struggle with internal operations, as many attorneys do. Of course, client files and notes are up to date, but what about billing and bookkeeping? As with any system, the way to be successful is to set it up right the first time.

Make the best use of computerized systems to be sure that billing information reaches the billing clerk in a timely fashion. Set a schedule for bills, and make sure they are sent out on time. Lagging bills will impact your cash flow since there aren't many clients who will call to inquire about how much they owe you.

Trusted employees are essential to your practice, especially if you employ paralegals or associates who prepare some of the casework. While it is hoped they will complete their work quickly and accurately, you need systems in place to monitor their progress.

Timelines for client cases can help keep everyone on track by providing deadlines and monitoring work flow. Shared tools like Google calendars can help the staff keep up to date on pending events and work in progress.

Time management is one of the most difficult areas for attorneys. With a multitude of client cases at various stages and new problems or complications popping up daily, keeping on top of workload is a feat in itself.

One way to improve effectiveness is to build in time buffers. Pace yourself by scheduling work out as far as possible and then building in blocks of time for emergencies or delays.

Stress is caused by schedules so tight they squeak, and anything unexpected causes a huge problem. If you find yourself caught up, get started on next week's work. Remember too to build in company events and down time to build the team and boost morale. Something as simple as a shared monthly meal can create goodwill and a great sense of cooperation among staff members.

Owning your own practice is a rewarding and exciting endeavor. Applying a little business savvy will make it more enjoyable and successful. ■



The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation.

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