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Business Valuations Seminar

October 18, 2018

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Brief Bio

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Academic

- Graduate Concordia MBA program – 2001
- Chartered Business Valuator (CBV) - 2005
- Lecturer McGill U: Business Valuations and Financing
- Advisor to McGill U : Diploma in Business Valuations
- Judge JMSB International MBA Case Competition

Business

- Equity Partner & GM of Hitek Logistic Group
- Previous experience in Banking, Manufacturing Start-up, M&A, Valuations , Financing Advisory Services

Topics For Today

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- Case Question – You are the investor
- Methods to Valuing a Business
  - Asset Based Method
  - Capitalized Normalized Cash Flow Method
- A look at actual valuation multiples - Transactions
- Insight into the MTL M&A market
- Hitek Logistic Inc.: A tale of value creation….
- Your most important take away from our time together
- Chartered Business Valuators Designation (CBV) – **Time Permitting**
- Discounted Cash Flow Method – **Time Permitting**

Reasons to Value a Business

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- Mergers and Acquisitions, Divestitures
- Litigation- shareholder disputes, divorces etc..
- Tax purposes – reorganizations, freezes
- Financial statement purposes – Fair value of intangible assets and goodwill
- To obtain financing
- Investing in a company
- Other

Business Valuations

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*"Quantifying the value of a business based on the **present value of future cash flows** generated from the business' assets and liabilities **at a specific point in time**."*

Purpose of Business Valuation

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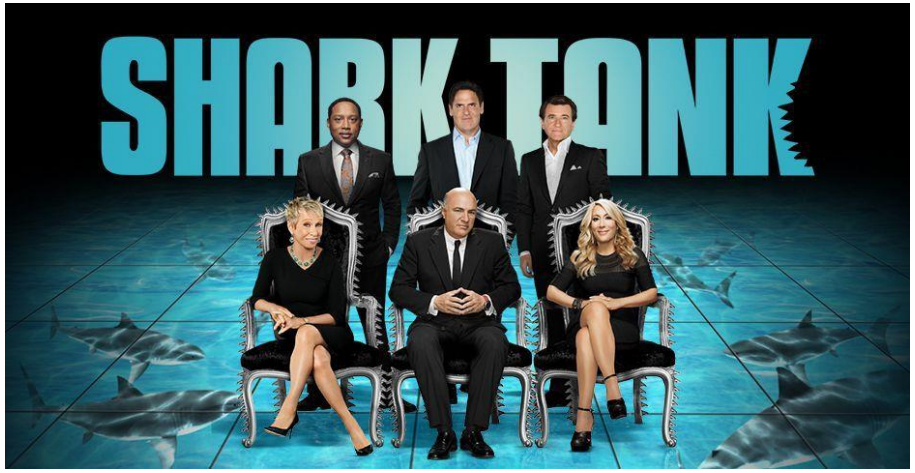

You are the investor !

Case

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A friend of the family is the owner of a company that manufactures healthy granola bars.

The company was founded in 2010.

She is looking for a young dynamic JMSB MBA grad to invest in her business.

She is seeking $500,000 for 25% of the business.

She likes her coffee black.

What information do you require to make your investment decision?

Factors to Consider When Valuing/Investing in a Business

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Management and Employees

- Strength
- Depth
- **Personal goodwill – owner**
- Experienced employees (low vs. high turnover)

Products and services

- Breadth
- Depth
- Intellectual property
- Positioning within the product/service life cycle

Factors to Consider When Valuing/Investing in a Business

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- **Financials**
  - How did she arrive at the value of the business?
  - History of profitability and growth
  - Strong cash flow with adequate debt coverage
  - Balance sheet supported by strong working capital and debt to equity ratios
- **Sales and Marketing**
  - **Client base – diversity vs. Concentration**
  - Sales channels – where and how are they selling product?
  - Brand – is it recognized in the marketplace
  - Effective advertising and promotion strategy (web/social media)
  - Identification and extensive knowledge of the target market

Factors to Consider When Valuing/Investing in a Business

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Information Technology

- Age and condition of IT infrastructure
- Efficiency and accuracy of reporting
- Use of technology in the production process
- Streamlined processes

Economy and Industry

- Strength and number of competitors
- Local vs. Global competition
- Growth prospects for both the economy and industry
- Overall economic conditions

Factors to Consider When Valuing/Investing in a Business

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- **Capex + Suppliers**
  - Age, condition and investment required in capital assets
  - **Supplier base – many vs. few**

- **Strategy**
  - Differentiation vs. Low cost vs. Other
  - Clear business model with a sustainable competitive advantage
  - Opportunities for synergies or economies of scale
  - Barriers to entry
  - Strategic posture vis-à-vis competition
  - Critical Success Factors

Factors to Consider When Valuing/Investing in a Business

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Legal & Regulatory

- Any contingent liabilities (ie . Lawsuits)
- Environmental issues
- What are my rights as a shareholder (minority vs. majority)
- Shareholders agreement
- Any regulatory (FDA) or government issues

Cultural Fit

- Do I share the same values and vision of my future partner?
- Do I like this individual? What do we have in common?
- Do we have complimentary skill sets?

Factors to Consider When Valuing/Investing in a Business

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My Operational Role

- What is my role? COO or CCM (Chief Coffee Maker)?
- My compensation?
- Can I pursue other interests outside of the business?

Smell test /gut check

- Does this make sense?
- What does my gut tell me?
- Putting the pieces of the puzzle together?

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What are the Risks and Opportunities?

Valuation Methods

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- Asset Based Method
- Capitalized Normalized Cash Flow Method
- Discounted Cash Flow Method – Time permitting

Asset Based Method

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- Focus on the Fair Market Value of the assets and liabilities of a Company.
- The Balance Sheet!
- Need to make adjustments to reflect the FMV of the assets and liabilities such as:
  - Real Estate
  - Equipment
  - Marketable securities
  - Others

Asset Based Method

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- In most cases the assets on a balance sheet are shown at the lower of cost (less depreciation) and fair market value (FMV)
- This is a conservative accounting rule
- We are more interested in FMV

Example

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	Book Value	FMV
Marketable Securities	$ 400,000	$ 900,000
Accounts Receivable	$ 1,000,000	$ 1,000,000
Inventory	$ 3,000,000	$ 3,000,000
Prepaid Expenses	$ 50,000	$ 50,000
	$ 4,450,000	$ 4,950,000
Properties	$ 550,000	$ 3,000,000
Equipment	$ 1,000,000	$ 1,500,000
	$ 6,000,000	$ 9,450,000
Liabilities	$ 4,000,000	$ 4,000,000
Shareholders Equity	$ 2,000,000	$ 5,450,000

When to Use This Method?

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- Valuation of a holding company (ie. Company that does not have any operating income)
- Company that has significant assets such as real estate or marketable securities
- In a “logical” transaction this is the minimum you would pay.

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CAPITALIZED NORMALIZED CASH FLOW METHOD

What Does Normalized Mean?

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- Revenues and Expenses adjusted for:
  - Non-recurring
  - Non-Operational
  - FMV

Example – Normalized Cash Flow

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	2015	2016	2017	2018
Sales	$4,000,000	$5,000,000	$6,000,000	$7,000,000
EBITDA	$400,000	$500,000	$600,000	$700,000

- EBITDA = Earnings before interest, taxes, depreciation and amortization
- Family run Company "I Love Bagels Inc." is a bagel distributor established in 1995
- Shareholder remuneration was $300k in each of the years. Industry benchmark is $200k
- The Company moved in 2015 and incurred moving costs of $100k
- The Company was involved in a litigation in 2016 with legal fees of $40k
- The Company received a settlement from the litigation of $250k in 2018

Example – Normalized Cash Flow

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	2015	2016	2017	2018
Sales	$4,000,000	$5,000,000	$6,000,000	$7,000,000
EBITDA (a)	$400,000	$500,000	$600,000	$700,000
Adjustments				
Shareholder remuneration	100,000	100,000	100,000	100,000
Moving expense	100,000			
Legal fees		40,000		
Legal settlement				(250,000)
Total adjustments (b)	200,000	140,000	100,000	(150,000)
Normalized EBITDA (a + b)	**600,000**	**640,000**	**700,000**	**550,000**

	-10%	avg	+10%
4 year average (rounded)	**560,000**	**620,000**	**680,000**

Example – Capitalized Normalized Cash Flow

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	Low	High
Normalized EBITDA - **Step 1**	$560,000	$680,000
Less: Income taxes - **Step 2**	(112,000)	(136,000)
Normalized after-tax cash flow	448,000	544,000
Less: Sustaining Capital Reinvestment - **Step 3**	(50,000)	(50,000)
	398,000	494,000
Capitalization rate (multiple) - **Step 4**	6	6
Enterprise Value - **Step 5**	2,388,000	2,964,000
Deduct: Interest bearing debt - **Step 6**	(350,000)	(350,000)
Equity Value (rounded)	**2,040,000**	**2,610,000**
Shareholders Equity @ FMV *	1,000,000	1,000,000
Difference = GOODWILL	1,040,000	1,610,000

** As per the Asset Based Valuation Method*

Risk vs. Reward

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- The multiple is the inverse of the capitalisation rate - a direct function of the risk of the investment

Rate of return	Multiple	# of Years for Payback
16.7%	6.0 X	6.0
20%	5.0 X	5.0
40%	2.5 X	2.5

When to Use This Method?

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- When the company is a viable going concern
- When cash flow is expected to be smoothly realized
- When historical cash flow is representative of future cash flow
- Typically this method works well for:
  - Distribution companies
  - Manufacturing companies
  - Capital intensive companies (Pharma, IT, Construction etc..)

Transactional - Multiples

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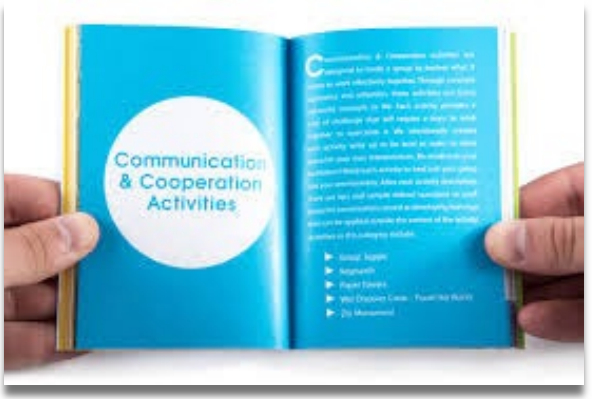
Source: Business Valuations Resources

Business Reference Guide 2018



Transactional - Multiples

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Advertising Agency

- 2 to 5 x EBITDA
- *"The digital sweet spot is a firm with technological prowess, owned IP, strategic vision and industry leading expertise in a hot category like mobile, social etc.."*

Construction Company

- 2 to 4 x EBITDA
- *"The business history is important, as is the value of the signed contracts to be completed and understanding how a company bills its work in progress."*

Transactional - Multiples

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Distribution Company

- 3.5 to 4.5 x EBITDA
- "*Suppliers, how many and will that continue for a new owner, under the same or better conditions. Current contracts with customers and account concentration issues are all of high importance when determining value.*"

Manufacturing Company

- 4 to 8 x EBITDA
- *"Companies that have patented products and proprietary methods will see a higher multiple. The transferability of the customer base will have a significant influence regarding price. Repetitive long-term contracts deserve a premium. Watch out for warranty exposure, product liability, obsolete inventory and excessive WIP. "*

Transactional - Multiples

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IT Company

- 3 to 6 x EBITDA
- "*Multiples may increase if selling company has secured government contracts.*"

E-Commerce Company

- 3 to 6 x EBITDA
- *"A business with little or no inventory is more valuable. Businesses with very high inventory are very difficult to value and sell: the business is the inventory. The more niche related the product, the higher the multiple."*

Transactional - Multiples

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Hotels & Motels

- 8 to 11 x EBITDA
- *"This sector is a hybrid between business and real estate. Valuations vary with multiple factors including real estate value, brand, market trends etc."*

Software Company

- 5 to 7 x EBITDA
- *"Recurring maintenance revenue adds more value. Recurring subscription revenue adds more value. Actual and replication cost per source code line is a significant measurement used by potential acquirers."*

What to Expect in the MTL M&A Market

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Macro Factors Impacting Valuations

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- We are still waiting for the Baby Boomers to retire
  - People are living longer
  - They are holding on to their businesses
  - They don't want to spend too much time at home or on a golf course
- It's a Sellers Market
  - Lots of buyers searching for opportunities (Local and International)
  - Low inventory of high quality mid-market companies
- Financing is relatively easy to obtain
  - Banks are active and competitive in the mid-market
  - They still want you to have some skin in the game

Type of Sellers

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- **The Umbrella Drink Seller**
  - No rush
  - Waiting for a great offer
- **The Health Motivated Seller**
  - Health problems
  - Motivated
- **The Distressed Seller**
  - Business challenges
  - Motivated
- **The Retirement Seller**
  - Looking forward to other projects
  - Motivated

Criteria Grid – Seller's Perspective

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BUYER	HIGHEST PRICE	QUICK EXIT	CONTINUITY	WELL FUNDED
Entrepreneur Individual		✔		
Competitor	✔	✔		
Management			✔	
Family			✔	
Private Equity/Family Office	✔	✔		✔
Search Fund				✔

Type of Intermediaries

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- **The Business Broker (Matchmaker)**
  - Has good transactional experience
  - May not have in-depth knowledge of valuation principles
- **The Accountant**
  - May not have transactional experience
  - May not have in-depth knowledge of valuation principles
- **The M&A Advisor – from a boutique or accounting firm**
  - Has good transactional experience
  - Has in-depth knowledge of valuation principles
- **The Entrepreneur or Mentor**
  - May or may not have transactional experience
  - May or may not have in-depth knowledge of valuation principles

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KPMG

NATIONAL BANK

Deloitte.

RBC Royal Bank

Advisors in MTL: $10M +

Raymond Chabot Grant Thornton

CIBC

pwc

EY

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BDO

RICHTER

MNP LTD

Advisors in MTL: $2M +

demersbeaulne

Crowe BGK

PSB.ca Boisjoli

CAFA

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WHAT IS YOUR KEY TAKEAWAY FROM THIS CLASS?

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QUESTIONS?

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Canadian Institute of Chartered Business Valuators (CICBV)

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- www.cicbv.ca
- CBV is the premier credential for business valuations in Canada/USA
- Only 1,800 members
- 200 + members in Quebec
- 6 courses with assignments and case studies (can be taken by correspondence or at McGill U and U of T)
- 6 National exams + 1 National final exam
- 1,500 hours of practical work experience

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- CBV is a leading curriculum in the global business valuations practice
- 95% of CBV's are Chartered Professional Accountants (CPA) and Chartered Financial Analysts (CFA)
- CBV's work in accounting firms, investment banking, government ie (Revenue Canada), Venture capital, Private Equity etc..
- CFA = General Designation, CBV = focus on Valuations
- CBV still relatively unknown in the finance world

CHARTERED
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DISCOUNTED CASH FLOW METHOD

Discounted Cash Flow Method

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- Trying to determine the present value of the **future cash flow** of a Company
- Relying on financial projections – **future oriented**
- Projection period = typically 5 years or more and Terminal period = 5 years + to infinity

When to Use This Method?

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- Used when a business or project has a limited life
- Start-ups whereby there is no history of earnings/cash flow
- High growth companies where the past is not indicative of future results
- Used when valuing a Company that has significant contract revenue (specific beginning and ending to the revenue stream)
- Used when valuing a Company that has uneven (volatile) revenue streams

Financial Projections

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- Who prepared the financial projection and for what purpose ?
- Do you have a complete set of financial projections (balance sheet , income statement, cash flow) ?
- What is management's track record in projecting financial performance ? (projected vs. actuals)
- Are the assumptions in line with historical results? Industry benchmarks? If not, why?
- Are the assumptions clear and consistent?
- If management is projecting significant increases in sales and profitability, is there also the related expenses/or investments required to reach these objectives?

Discounted Cash Flow Method

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Need to validate these figures and challenge the hypothesis

		For the Years Ending September 30,					
							Terminal value
	(Actual) 2018	2019	2020	2021	2022	2023	2024 & Thereafter
Growth rate		20.0%	20.0%	20.0%	10.0%	10.0%	2.0%
Revenue Step 1	$12,000,000	$14,400,000	$17,280,000	$20,736,000	$22,809,600	$25,090,560	$25,592,371
Normalized EBITDA Step 1	**$1,800,000**	**$2,160,000**	**$2,592,000**	**$3,110,400**	**$3,421,440**	**$3,763,584**	**$3,838,856**
	15%	15%	15%	15%	15%	15%	15%
Income taxes Step 2	(450,000)	(540,000)	(648,000)	(777,600)	(855,360)	(940,896)	(959,714)
Less: Investment Sustaining Capital Investment Step 3	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)	(300,000)
Less: Investment in Working Capital Step 4	(50,000)	(360,000)	(432,000)	(518,400)	(311,040)	(342,144)	
Net discretionary cash flows (rounded)	**$1,000,000**	**$960,000**	**$1,210,000**	**$1,510,000**	**$1,960,000**	**$2,180,000**	**$2,580,000**

Need to validate these figures and challenge the hypothesis

Based on a formula : Year over year change in Current assets - Current liab

Usually based on an average of previous years investments

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We capitalize the terminal value
This is the value of the company from 2024 onwards.
We now have to discount this value back to 2018

	For the Years Ending September 30,					
	2019	2020	2021	2022	2023	Terminal value 2024 & Thereafter
	$	$	$	$	$	$
Net Discretionary Cash Flows (a)	**$960,000**	**$1,210,000**	**$1,510,000**	**$1,960,000**	**$2,180,000**	**$2,580,000**
Growth rate					2%	
Cap rate					(29% -2%) = 27%	1/27%
Multiple						3.70
Discount Rate	**29.0%**				Step 6	$9,555,556
	1	1	1	1	1	
Discount Rate	1.29	1.29	1.29	1.29	1.29	
This is the formula if we do it manually →	1/(1+29%)	1/(1+29%)^ 2	1/(1+29%)^ 3	1/(1+29%)^ 4	1/(1+29%)^ 5	1/(1+29%)^ 5
End of year present value factor **(b)**	0.775	0.601	0.466	0.361	0.280	0.280
Present value of net cash flows (a x b) **Step 5**	744,186	727,120	703,409	707,778	610,250	2,674,899
% of total	12%	12%	11%	11%	10%	43%
Sum of Discounted Cash Flows - rounded						**$6,170,000**

	Low		**High**
Enterprise Value (value of int bearing debt + equity)	$5,860,000	**$6,170,000**	$6,480,000
Less: Interest bearing debt **Step 7**	(2,000,000)		(2,000,000)
Equity value - rounded	**$3,860,000**		**$4,480,000**

Largest part of the DCF in many scenarios

As per the balance sheet