Joe Sullivan's Guide to SUCCESSFUL INDEPENDENCE in the 21st century

Chapter One: How to determine your company's value

All the talk about how independent distributors are being squeezed out by the big nationals is backwards. Right from the beginning, the independents have been leading the drive to make the giants grow. Oh, I admit that things are changing, and the big guys really are becoming dominant in more and more markets, which is making the game much harder to play. In truth though, the growth of the giants has come mostly through acquisition of independents who sold out for reasons that had little to do with competition. They sold their businesses because they didn't know of anything else to do. They wanted to retire, or provide for an estate, or go on to another career. Selling out seemed the only option (and for many it is indeed the best thing to do), because they had no forward looking strategic plan, no obvious successors, no management team to step in when the owners got tired, and no knowledge of some of the other strategies that may be available.

Good news! There are a variety of ways to get out of a distributorship, get some liquidity, or transfer ownership, without selling to the giant down the street. Some can involve significant tax savings for both the owners and their families and estates.

> . . . lack of planning sometimes gives you the patriotic satisfaction of paying down more than your share of the national debt through taxes on your estate or on the sale of your business.

Plan, plan, plan

Planning opens up opportunities. Lack of planning limits or even eliminates choice; however, lack of planning sometimes gives you the patriotic satisfaction of paying down more than your share of the national debt through taxes on your estate or on the sale of your business. The market value of your business is the cornerstone of all the strategies we will discuss, including outright sale. It is the first thing we will look at in this series of articles.

There are lots of ideas floating around about how distributorships are valued. However widely used they may be, many simply will not stand up in the eyes of the IRS, the courts or regulators.

The FMV standard

The valuation of a business is not a simple number based on Book Value, Net Asset Value, or "values" computed on the basis of rules-of-thumb, like, say Assets plus One Year's Earnings, or Five x EBIT (Earnings Before Interest and Taxes). Courts, the IRS, regulators and financial professionals use a concept called Fair Market Value, or FMV for short. Computation of FMV takes into account what is happening in

continued on page 44

the market, and may even use the familiar rules of thumb as a part of the overall process, but it looks primarily to the *sustainable earnings capacity* of the business. In transactions involving estates, ESOPS, Family Limited Partnerships, divorce, shareholder buyouts, etc., FMV is almost always the standard employed.

Why go to the trouble to compute FMV instead of just making an estimate based on what other distributorships are bringing at sale? The biggest reasons are that information on sales of companies in this industry is very scarce, and that each company is a bit different. While you hear the stories, "X Electric sold for 7x EBIT," what do they mean? What were X Electric's financial condition, history and prospects? Was the 7x EBIT the total transaction price, out of which the seller had to pay off trade payables and financial debt, or did the buyer assume part of these?

These are critical pieces of information, and they are in very short supply. Getting data is a challenge even for firms like ours that advise on many transactions each year and are well familiar with the market.

The significant differences among distributors make the job even harder. For example, the pricing of an $80-million multi-branch Allen-Bradley shop has little in common with that of a $6-million single-location firm with no leading brand-preference line. The absence of reliable information means that there is no easy way to check market value. If you were valuing a listed security, you could conveniently look up trading prices. You can't do that with a privately held electrical distributor.

Keeping all of that in mind, how do you estimate the value of your business? Start by taking a hard look at EBIT. Of course, in most distributorships, EBIT in its raw form is not too meaningful, simply because most owners run their companies to pay themselves well and pay Uncle Sam as poorly as possible. So there is a process called recasting which involves taking out the extra overhead that relates to the owners, and also such extraordinary expenses as branch closing costs, and losses on sale of equipment. You start with the income statement as reported, and work up a spreadsheet that shows all of the changes, positive and negative, by line item. When you have worked through everything, you will have a *Recast Statement of Income.*

The goal is to show what the business can do and how it has performed on a realistic basis, if run to show maximum profit commensurate with long-term growth. Figure 1 shows a simplified recasting statement for a smaller firm.

If we were looking at the real thing, instead of a greatly simplified example, the adjustments, or "add-backs" as they are often called, would be done on a detailed and documented line-item basis. In this example, however, only two adjustments are made. The first, in the amount of $58,000, reflects conventions, meetings, dinners, shows and the like that are perfectly legitimate expenses for owners, but which would probably not be in the budget for a hired manager.

The second adjustment in the amount of $420,000, backs out all of the salaries, life insurance, medical reimbursements, automobile expense and other compensation, perks and benefits of the owners. However enough money is left in to cover the compensation and expenses of a good hired manager.

In the case of a branch or division, we would also be backing out various corporate charges. A number of common adjustments are shown in Figure 2. "Add-backs" are added to EBIT to increase the bottom line. "Deductions" are subtracted. The list is not at all comprehensive, but will help give you the idea.

Once you have navigated the accounting issues involved in recasting—and at times they can be quite confusing—you are

Figure 2

Add-backs	Deductions
Owner's compensation and perks	Cost of a high-quality manager
Extra travel and entertainment costs	Investments income
Discontinued operations	Unrelated business income
Interest expense	Interest income
Certain corporate charges	Intra-company transactions
Certain insurance expenses	
Comp. for non-working family	

Figure 1 Examples of a recasting statement of income

	REPORTED		RECAST
Revenues	$16,000,000		$16,000,000
Cost of goods sold	12,480,000		12,480,000
Gross Profit	3,520,000		3,520,000
Sales	1,500,000		1,500,000
Warehouse & Delivery	1,000,000		1,000,000
Travel and Entertainment	68,000	(58,000)	10,000
Administrative	600,000	(420,000)	180,000
Total SG&A	3,168,000		2,690,000
EBIT	$ 352,000		$ 830,000

well on the way to determining FMV. The Recast Statement of Income shows what the business can earn before interest and taxes (of course most businesses do pay interest and taxes, but because these vary a great deal and can greatly confuse the issue, the common practice is to evaluate distributorships on EBIT).

Using the recast EBIT data, it is then possible to create a reasonable forecast of the next few years. This estimate, firmly grounded in actual historical results, is the most important basis of Fair Market Value.

The balance sheet

Next, we turn to the Balance Sheet, and immediately hit a big disconnect between financial theory and real world transactions involving electrical distributorships. This disconnect exists because many distributors consider "assets" and "book value" to be significant determinants of value. Therefore, many distribution businesses are sold on the basis of "assets plus blue sky," or "net asset value." Of course the more sophisticated buyers and sellers will adjust asset values to make them more realistic than historic book numbers might indicate. Furthermore, it often happens that "net asset value" is very close to earnings-derived value. Nevertheless, if you rely on asset value or net worth for purposes of estates, taxes, divorces, transfers of stock within a family or to employees, or any non-arms-length transaction that might someday be reviewed by the courts, you are setting yourself up for potentially very expensive problems.

To understand why Balance Sheet net worth is not a reliable indication of value, consider the cases of two distributors, each doing $35mm in sales. Distributor "A" has inventories of $7mm, and a net worth of $3mm. Distributor "B" has inventories of $4mm, and a net worth of $2mm. Which is more valuable? How can you say without knowing what they earn?

Now suppose that "A" is a traditional distributor with decent gross margins of 19%, and EBIT of $1mm. Further suppose that "B" does a significant high-tech training business, has overall gross margins of 27%, and EBIT of $3.5mm. Is "A" worth more than "B" because it has more inventory and a higher net worth? Obviously it is not.

The Balance Sheet can be materially misleading. However, the reality is that the Balance Sheet does affect the market value of electrical distributors, so we cannot ignore it.

Like Income Statements, Balance Sheets often must be adjusted to accurately reflect the condition of the business. The adjustments tend to be simpler though. You generally take cash as reported, subtract assets that are not related to the business (such as investments or condominiums for personal use), and add the LIFO reserve, if any, back to the inventory values. You may also make adjustments for fully depreciated assets that actually still have value; warehouse racking often falls into this category, as do wire machines.

continued on page 46

You back out the current and long-term portions of bank debt and the like. This is done simply because the business is being valued on EBIT (Earnings Before Interest and Taxes); so to be consistent, we back out the debt that generates the interest. This debt does not go away, of course. It must be deducted from the final valuation.

Unfortunately, like so many things in life, Balance Sheets can be subject to complicating factors. Inventory values are often less than meet the eye. There may be materially more cash than is needed for working capital. Accounts Receivable may be risky. All these things must be considered, and appropriate adjustments made. We at JS&A have had the fun of valuing more than one business that had excess cash. The challenge is to figure out how much is reasonably needed to run the business. The surplus is counted as additional value over and above the value of the going concern. On the other hand, we have also had to plough through all too many inventory issues, the outcomes of which have rarely resulted in increased value.

Estimate value

With an adjusted Income Statement and Balance Sheet in hand, you are ready to take a stab at estimating value. Professionals have a toolkit that contains over 20 approaches to value. Most are simply different angles on a concept called the *Discounted Present Value* of the business' cash flows (generally using EBIT as a way of estimating cash flow, although there are some theoretical problems with this).

Discounted Present Value is an intimidating name for a simple idea. A dollar today is worth more to you than a dollar you won't get for a year or two. You could think of it as interest running in reverse. If you loan someone $100 for a year at 22% simple interest, at the end of the year they will give you back $122. By the same token, if you have been promised $100 twelve months hence, at a 22% discount rate, that future income has a worth today of $78.

The same reasoning is applied to the EBIT a company will earn in future years. We figure the value of the business as the total of its future EBIT, as discounted back to today.

The two biggest questions are: a) What is a reasonable estimate of future EBIT?; and b) What is the discount rate that should be used? The EBIT estimate comes straight from the recast and projected income statement. That is pretty simple and straightforward. On the other hand, calculating which discount rate to apply is a technical matter that makes most folks' eyes glaze. Suffice it to say that given current money market conditions, for distributors in good condition, with sales of $50mm or

Deal pricing guidelines

There are many different ways that electrical distributorships are sold. Some can be quite creative. The most common is an Asset Purchase, in which the buyer receives specified assets rather than shares of stock. Despite the name, the pricing of an Asset Purchase is absolutely not restricted to the book value of the assets being sold. This is because the buyer wants the ongoing business as a going concern, and that obviously has more value that a mere pile of used assets. The Asset Purchase is just a way for the buyer to structure the deal to get maximum tax advantages with a minimum of liability exposure. Unfortunately, an Asset Purchase is frequently very disadvantageous to the seller in terms of taxes. A Stock Purchase, on the other hand, tilts the tax advantages to the seller. Sometimes the parties can agree on a deal value, and then work with their respective tax accountants to find a structure that optimizes benefits to both.

Here are some guidelines for deal pricing:

- **Multiples of EBIT generally run between 3X and 8X, with the lower end of the range for smaller companies with some problems, and the high end for larger companies, those with leading brand-preference industrial lines (Rockwell, Siemans), or those with exciting and clearly defined strategic niches;**
- **The most commonly seen multiples are 5X and 6X EBIT;**
- **Certain large buyers use a ratio of net sales to cap deal pricing regardless of EBIT-for example, they may pay the lower of 6x EBIT or 50% of net sales;**
- **Distributors under $15mm or so in revenues may find it hard to locate an interested buyer, and often sell for multiples of 5X or less (absent an exciting niche), while contractor houses under $8mm to $10mm in size may be very hard to sell at all unless a larger company has a local branch into which they can be combined;**
- **Buyers will look hard at the quality of the business, its customer base, and its operations when formulating an offer;**
- **Strategically placed companies with low EBIT sometimes sell for Net Asset Value if that is higher, but the buyer usually (but not always) assumes less of the liabilities in such a transaction;**
- **Smaller transactions are more often keyed to Net Asset Value, which if low, can pull a deal price down into the lower EBIT range;**
- **Buyers usually assume accounts receivable, and pay off normal trade payables and other current liabilities over and above the stated deal price—however, they normally do not pay off bank lines and other long-term debt.**

There is much industry gossip about transactions that went for much higher pricing. Some of it is actually true. However, a close look at any very high value transaction will reveal important strategic considerations, and unusually strong value propositions in the companies being sold. Strategic considerations might, for example, include geographic coverage of desirable national accounts, leading brand-preference lines—especially Rockwell/Allen-Bradley—or very clearly defined and profitable niches with strong account relationships.

less, the rate will fall in the range of 20% to 25%, depending on United States long bond rates, among other things. A rate of 22% to 23% won't be too far wrong. Larger companies may call for lower rates. Figure 3 works the numbers for our greatly simplified example from Figure 1.

Assumptions

As you doubtless noticed, there are a number of assumptions embedded even in this simple five-year projection. The biggest of these are the growth rate and the EBIT percentage. In an actual case, those factors would be estimated by taking a hard look at the distributorship's history and future prospects, and going through a careful forecasting process. Just to be simple and easy, in the example a growth rate of 5% per year is assumed, together with an EBIT of 5%.

Another difference between the example and what would be done in a real valuation is that you would carry the forecast out for more than five years, and use certain techniques to figure the value of the business at the end of forecast period.

However it may vary from reality, though, our example does clearly show the effect on future EBIT of discounting, and how the stream of discounted future EBIT is added up to form an overall value. The current year's earnings are worth 100 cents on the dollar. By the time we get to future year five, $1,021,000 in EBIT has a present value of only $509,000.

This discounting effect grows with each additional year of future EBIT. When all the forecasting and discounting is done, all the discounted future EBIT values are added together to compute the Net Present Value. In other words, in the example, the estimated total value right now today of the EBIT generated this year and for the next five years is roughly $3.9 million. This Discounted Present Value of the EBIT, with some consideration for the present value of the business assets at the end of the forecasting period, is the single most valid and reliable estimate of the value of a distributorship.

Lets put it all together, using three approaches: Discounted Present Value; Multiple of Earnings; and Adjusted Book Value. The use of three or more approaches is a normal professional practice, so that one approach will tend to confirm another. Figure 4 lists out the details.

In the above we have taken the Net Present Value approach, the Multiple of Earnings Approach, and Adjusted Book Value, and formed an estimate of Fair Market Value using a weighted average. The weighting is a matter of judgment, with no technical magic connected with it. It is an easy way of putting

continued on page 48

Figure 3 Examples of discounted present value of EBIT

Based on recast statements of income in 000's

	Current	Future 1	Future 2	Future 3	Future 4	Future 5
Net sales	$16,000	16,800	17,640	18,522	19,448	20,421
EBIT	830	840	882	926	972	1,021
Present value of EBIT 23% discount factor	830	731	668	610	557	509
Total Net Present Value	$3,904					

Figure 4

Simplified Valuation of a Distributorship		Approach to Value	Computed value	Weighted value
Current year EBIT	$ 830,000	Multiple of EBIT	$4,150,000	x2= 8,300,000
NPV of EBIT	5,200,000	NPV of EBIT	5,200,000	x2=10,400,000
Adjusted Book Value	4,500,000	Adjusted Book Value	4,500,000	x1= 4,500,000
Debt	2,000,000			23,200,000
Earnings Multiple	5x		Weighted Average	4,640,000
			Less Debt	2,000,000
			ESTIMATED FMV	$ 2,640,000

the emphasis on the more important approaches to value.

As discussed above, *Adjusted Book Value is not an accepted determinant of value*, but is commonly used by distributors in buy/sell transactions. Because it has an impact on the market, we cannot ignore it. We do, however, give it less importance, or *weight* in our computations.

Multiple of Earnings is one of the most well known and accepted approaches to value. We gave the company in our example a fairly middle-of-the road multiple based on current market conditions. We have already discussed Net Present Value of EBIT. After all the computations have been performed, the estimated value of the business on a debt-free basis is $4,640,000. As it happens, this particular business has $2,000,000 in debt. This is subtracted, to reach a final Fair Market Value estimate of $2,640,000, as bank lines and other non-trade debt are normally not paid off as part of the transaction.

Caution

One big yellow flag must be waved hard right now. Everything we have said applies to the value of 100% of the business. Valuations of fractional interests get tricky. For example, a 51% interest is worth much more than 51% of the business, because its owner controls the business. The controlling shares are valued with a so-called *control premium*. The other side of the coin is that interests of less than 50% are discounted. Under some circumstances, other kinds of discount factors can affect value as well.

Whatever your goal for sale, retirement, estate planning or liquidity, the starting point is to get a handle on the value of the business. Valuations can be pretty technical, but the process meets the common sense test once you know what is going on. *Any valuation for a court, the IRS or a regulatory agency, must be performed by a qualified third-party expert.* Of course, it you are just thinking through your options in a preliminary way, you can apply the method outlined here and get at least a decent idea of how things will shake out.

If you are contemplating an outright sale of the business, the best approach is get as much information on the current market as possible and try to figure how your company fits into the overall pattern. For sale purposes, try to *think in terms of ranges of value*, rather than spot estimates such as those produced by the FMV exercise above. The box on Page 46 has some basic current market information.

Joe Sullivan is president of Joseph Sullivan LLC & Associates, a consulting firm which helps electrical distributors build top performance, plan for the future, and buy and sell companies and branches. He can be reached at 972-463-1125 or josephsullivan1@earthlink.net.