Zachary Scott
INVESTMENT BANKERS

IN$IGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
FALL 2006

Value—In the Eye of the Beholder

Not everyone looks through the same economic lens.

by William S. Hanneman

Businesses are worth different amounts to different owners. This seeming anomaly is the result of different owners' abilities to influence the amount, timing, or predictability of the free cash flow generated by the operation of the business.

FREE CASH FLOW

Far from valuing businesses using multiples applied to historic EBITDA, sophisticated investors assess value based on the present value of expected future free cash flow. Free cash flow is the cash that is available to pay suppliers of capital.

The equation (top of facing page) specifically says that free cash flow is the product of sales times the operating profit margin, less taxes and the incremental investments in working and fixed capital necessary to grow the business (capital expenditures in excess of depreciation).

Discounting all future free cash flows to the present at a rate that reflects the blended returns demanded by capital providers yields a measure of the value of the enterprise—commonly referred to as Enterprise Value ("EV").

Readers may recognize this equation as the "Discounted Cash Flow" approach to company valuation. All future cash flows (shown in the numerator of this DCF equation) are discounted to the present ("PV") by the Weighted Average Cost of Capital, ("WACC"), a measure of the riskiness of the free cash flows. Lower costs of capital are associated with less risky (more predictable) businesses. Often times, this means the business can support greater financial leverage and, because debt is cheaper than equity, the weighted average cost of capital is lower. Less predictable cash flows require financing with a higher proportion of more expensive equity, which results in a higher cost of capital.

> **Because the value of an enterprise is the result of the present value of all future free cash flows, the timing of those cash flows has a meaningful impact on value.**

Deducting the amount of debt from the enterprise value leaves the remaining value for the shareholders. Shareholder value grows as Enterprise Value increases and as debt is reduced.

The Enterprise Value equation serves as the Rosetta Stone for deciphering why businesses have different values depending on who the owners are. In using the variables in this calculation, one can contemplate various ways to influence value based on possible changes in the amount, timing, or risk of future free cash flows.

INCREASE CASH FLOW

An increase in free cash flow is the most common way to create value. This can be accomplished in a variety of ways, from consolidating back office or sales functions, cross-selling product lines or improving asset utilization by eliminating excess capacity. Some buyers may, for example, be able to increase production without as much capital spending. Others may be able to reduce the cost of production inputs.

ACCELERATE THE TIMING

Because the value of an enterprise is the result of the present value of all future free cash flows, the timing of those cash flows has a meaningful impact on value. Accelerating free cash flow creates value, delay destroys value. Buyers may be able to accelerate cash flows, for example, by rolling out a regional product through an existing national distribution system or by speeding up product development.

REDUCE THE RISK

Reducing the risk of the free cash flow is a bit more complicated. However, it can be accomplished by improving the predictability of the cash flows. Ways to accomplish this may include converting customer relations from invoices to contracts, diversifying the customer base, or hedging input costs.

VALUE DRIVERS

When selling a business, we are always assessing how the value equation could be changed for each of the prospective buyers in a manner that would add value. Understanding how a buyer may be able to influence cash flow helps determine how that particular buyer will value the business (or at least, what value the buyer could justify).

AN EXAMPLE

We represented for sale a privately held business that manufactured and marketed a branded food product distributed in the Pacific Northwest. Although demand for the product was growing rapidly, pursuing national markets was a slow and expensive proposition.

CALCULATION OF FREE CASH FLOW

Free Cash Flow = [(Sales X Operating Profit Margin) (1-tax rate)] + depreciation — incremental working and fixed capital investments

CALCULATION OF ENTERPRISE VALUE ("EV")

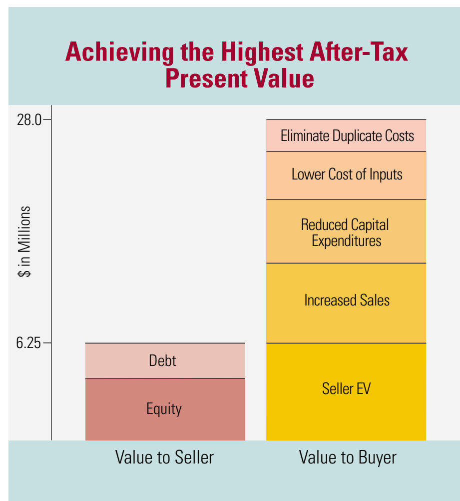
EV = PV [Free Cash Flow/Weighted Average Cost of Capital]

CALCULATION OF SHAREHOLDER VALUE

Shareholder Value = EV — Debt

(continued p.2)

The owner was concerned that if he did not move more quickly, more agile competitors would emulate his product to fill demand. He reached the conclusion to sell the business to a national food company that could plug the product into its existing national sales force. In addition to increasing revenues, the buyer had the infrastructure to reduce operating and administrative costs. Customers that would have taken our client years to cultivate were already customers of the buyer thereby meaningfully accelerating revenue generation. The buyer also already had factories in multiple markets that could process the product with little incremental capital spending. In addition, the buyer, a much larger diversified branded food products company, had access to much cheaper sources of raw material and capital. Incorporating all of these attributes into the value equation resulted in the buyer's ability to justify a value four times what the business was worth as operated by our client.



CONCLUSION

The buyer who can justify paying the most is the one that can best increase the amount, accelerate the timing, or reduce the amount or cost, of capital employed. Bear in mind that, while different buyers may be able to justify paying higher amounts, they still won't pay more than they have to. Therefore, achieving the highest shareholder value requires that a sale process be conducted that brings all logical, financially qualified buyers to the opportunity simultaneously. ❖

Zachary Scott
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1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com