

WHAT IS YOUR COMPANY WORTH?

MEASURING THE VALUE OF SMALL TO MEDIUM SIZED COMPANIES

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You had a big idea a few years back and you built a great company. So what is the value of your company today? And will your future plans enhance or erode that value?

When cash returns exceed your cost of capital, you are creating value. This is a simple concept, but tricky to apply, especially for private companies. At Pacific Mercantile Bank, we have given a lot of thought to the application of modern portfolio theory to small and medium sized enterprises. And we have some insights on measuring and building the value of smaller companies. While no one can tell you the value of your company without a significant time investment, in this paper we will share a few tenets of finance that may provide a useful framework for thinking about your company, expected performance and the implications for value.

Expected free cash flow can define almost any company's value. Free cash flow is everything left over (in cash) after bills are paid and re-investments to keep the company up and running have been made. When you see acquisition prices quoted as multiples of revenue, profit, and even EBITDA, these are only proxies for the expected cash flow producing capabilities of the firm.

All that matters is how much cash a company can generate for its owners less the investment necessary to get it. Having said that, adjustments are made for time periods required to get to the cash flow, as well as adjustments for risk that expected cash flow might not develop. But understanding that a company's value always ties back to free cash flow is the "Rosetta Stone" of corporate valuation.

How do you figure it out? Spend some time with your banker and build a forecast of your balance sheet, income statement and cash flow. Five to six years is usually long enough to permit a stabilized performance to emerge, including a cycle of reinvestment. Annual capital expenditures are volatile for most small companies, and re-investment requirements are more clearly identified in a longer term forecast.

The forecast should be neither conservative nor aggressive. It should be a reasonable estimate of the company's potential. Discretionary expenses, such as unusual travel or entertainment or the payroll to your unproductive brother-in-law, should be excluded. You want to showcase the cash flows available to any new investor. Distributions to shareholders or owners and payments on principal and interest to debt holders should be added back. The value of the enterprise is independent of how the cash is distributed.

Once you and your banker have built the forecast, pull the free cash flow out of the forecast. That's the excess cash that piles up on the balance sheet without consideration of distributions.

Cash flows need to be adjusted for risk and time to deliver. Timing is a fairly straightforward concept. Cash flows ten years from now are worth a fraction of cash coming in tomorrow. The risk adjustment is substantially trickier and space does not permit a discussion of all the issues, theories or nuances of risk. Simply stated, the risk adjustment factor, or discount rate, is basically the opportunity cost of having your capital invested in a similar project.

The expected return or "cost of capital" is made up of two components: the cost of debt and the cost of equity, multiplied by their respective shares in the capital structure. We recommend using target capital (the ideal mix of debt and equity) as opposed to what you are currently carrying. In our example below, we assume a 50% debt to capital mix, which is not far from where most businesses operate. Capital is simply debt plus equity.

For these purposes, the cost of debt is not the rate your current lenders charge. Most banks and finance companies lend short-term and base the rate on short-term indexes like Prime. Today's Prime is not a good representation of where Prime may be in five years

from now. We suggest using a long-term rate in your forecast, for example, the 30-year Treasury, plus a credit spread. If you are a near prime borrower today, we suggest using a rate of 6%, which is a more reasonable estimate of what you will likely be paying over the long-term.

The cost of equity is a completely different story. Nobel prizes have been awarded to researchers for trying to determine what rate of return equity investors are demanding. Even more confusing, there is little agreement on what the cost of equity is, or should be, for a non-diversified investor (namely, the entrepreneur). The research done on equity premiums has largely been focused on public companies where information and trading histories are readily available.

The only consensus in the literature for private companies is that they should earn an additional return premium over exchange-traded stocks, to compensate for the additional risk of size, lack of liquidity and the inability to diversify company specific risk. The amount of premium is still subject to debate, but a proxy is better than nothing, so for purposes of our example, we assume a cost of equity of 16%.

In our example, the weighted average cost of capital is 50% of the cost of debt, adjusted downward for its tax deductibility, plus 50% of the cost of equity. That is: $[0.5 \times 6.0\% \times (1 - .40)] + [0.5 \times 16\%] = 9.8\%$. So the weighted average cost of capital in our example is about 10%. This number may seem low, because we are used to hearing about higher returns in the press. But those returns are on equity, not total capital. We are measuring cash returns (not earnings) on total capital (not just equity).

A company's capacity to produce free cash flow relative to the total capital required to produce it is the heart of company valuation. There are many other issues that have to be considered as you attempt to value your firm, but establishing a benchmark and measuring yourself against it is a great start.

Once a cash flow model has been set up, management should run "what if" scenarios. Run a series of scenarios against the model to determine whether your strategies increase or decrease value. Will the cost of your new expansion plan increase the value of your firm or just the size of your firm? (The two are not always related.) Is taking on a new, large customer at lower margins and increased working capital burden worth it? What steps can you take to maximize value? What is a single margin point worth in total company value? And, most importantly, if you execute your most optimistic plans, what will your company be worth?

*"At Pacific Mercantile Bank, we call it **Horizon Analytics.**"*

Magnitudes of change can be calculated as well. Take the difference between your return on capital and your cost of capital and multiply it times the capital deployed. Multiply that number times the number of years you expect to sustain the returns, and voilà, that's the value being created above the capital invested.

If you are earning, or expect to earn, cash returns in excess of your cost of capital, you are creating value. If not, value is static and maybe eroding. Being able to represent all the variables in your business in a single model that can "price" decisions, can be a big assist in decision making. Yes, it is much more complicated than suggested above, and yes, there are assumptions that can be challenged, but it's a compass. It can guide you in the right general direction.

In finance, the definition of risk is uncertainty. One of the worst things a business can encounter is a surprise, and so the banker's role is to help business owners anticipate those surprises and plan accordingly. Contingency planning is about navigating challenges as well as capitalizing on opportunities, looking into the future, far beyond a company's day-to-day activities. At Pacific Mercantile Bank, we call it *Horizon Analytics*.

You do not want your first evidence of the value of your company to be in the form of a takeover bid. For the sake of your business's future, choose a banker who is committed to knowing your business better than anyone else in your professional network, and to helping you measure and maximize the value of your company.

Pacific Mercantile Bank is unique from other business banks. We help companies navigate the challenges of growth, restructure, and the inevitable unexpected event. We take the time to understand the business and the business owner's objectives.

PMB's Horizon Analytics® serves as a guide for business success, providing milestones along our client's road to reaching their vision. The ability to offer valuable financial insight into the current state and potential future is a game-changing service for our clients.

We deliver insightful, forward-looking cash management and credit solutions tailored to both the short-term needs and long-term objectives of a business when Horizon Analytics is combined with our bankers' skills. That is what sets Pacific Mercantile Bank apart from other business banks.

