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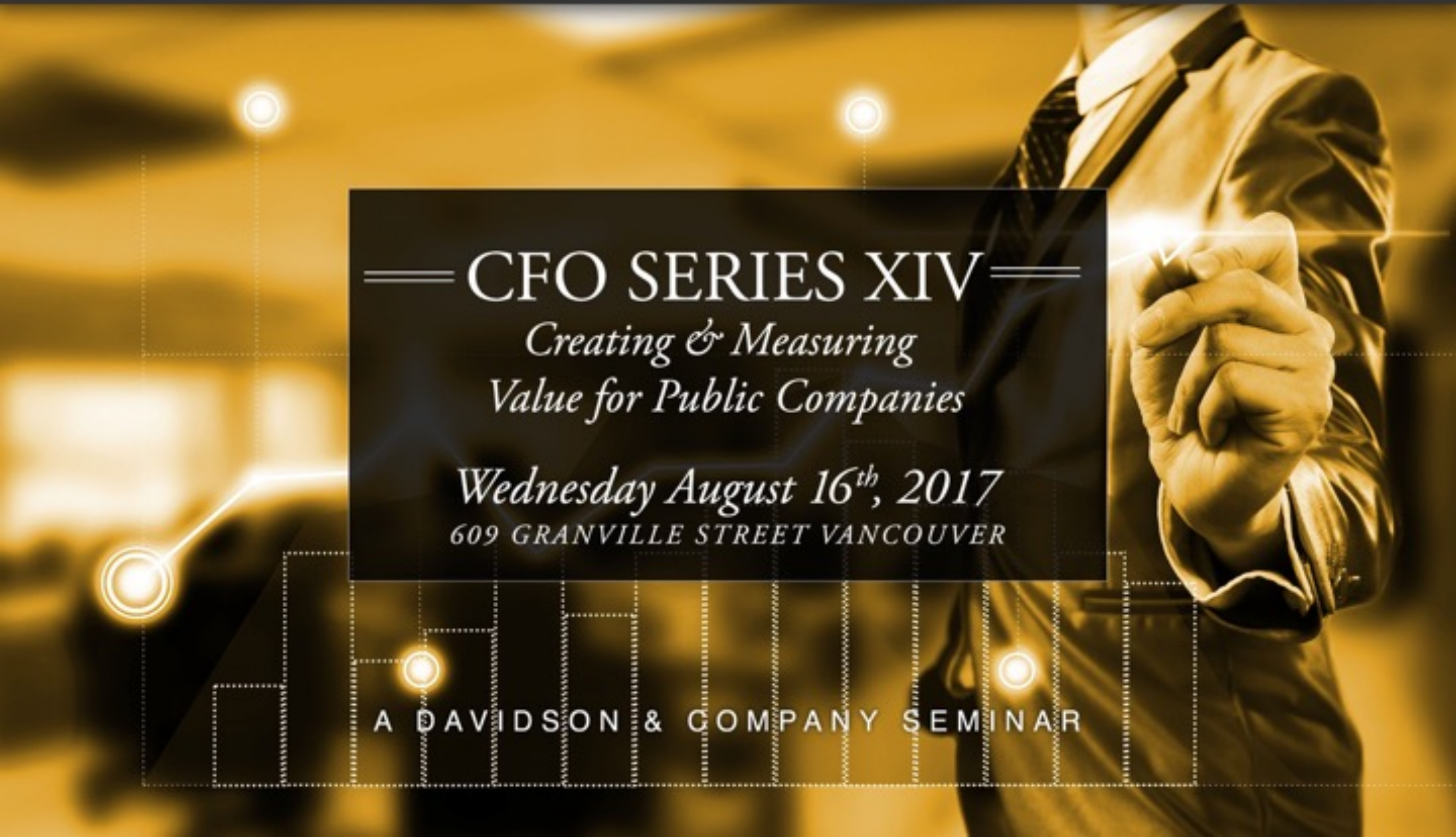

CFO SERIES XIV

Creating & Measuring Value for Public Companies

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609 GRANVILLE STREET VANCOUVER

A DAVIDSON & COMPANY SEMINAR

Creating and Measuring Value in Public Companies – Part I

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Davidson & Company - Valuation and Advisory

Disclaimer

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What is Value?

- **What is Value?**
  - **Fair market value?**
  - **Fair value?**
  - **Price?**
  - **From who's perspective?**
    - » **Management**
    - » **Shareholders**
    - » **Analysts**
    - » **Auditors / regulators**

What is Value?

- **Fair market value**
- **Fair value**
- **Price**
  - The only true way to determine the price achievable for a business is to expose it to the open market and negotiate a transaction with another party

What Drives Value?

- **Value drivers**
  - **Cash flow**
  - **Risk**

How is Cash Flow Measured?

- **Revenue**

  - Normalized operating costs

  - Income tax

  - Changes in working capital

  - Sustaining and growth capital expenditure

  = After-tax discretionary cash flow

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What Risk?

- **Probability of cash flow being realized**
  - **Near term (1-2 years)**
  - **Future (3-5 years)**
    - » **Terminal value (after projection period)**
      - **The majority of value is in the terminal value**

From Who's Perspective?

- **Perceptions**
  - **Management's**
  - **Market's**
  - **Auditors / Regulators**
- **The higher the <u>perceived</u> risk – the higher the discount rate**

How is Risk Measured?

- **If used in a DCF model the discount rate is almost always the Weighted Average Cost of Capital ("WACC")**
- **[After-tax cost of debt * % Debt financing] + [Cost of Equity * % Equity Financing]**
  - **Example: [8%*(1-.25) * 10%] + [20% * 80%] = 22%**
  - **Risk is contained in both the cost of debt and the cost of equity**

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What Drives Value?

Increase in cash flow

Decrease in risk

What Drives Value?

- **Factors impacting cash flow**

Revenue

Gross margin

Operating margin

EBITDA

Costs

Taxes*

Working capital*

Capital expenditure*

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What Drives Value?

- **Factors impacting risk**

Aggressive projections

Unsupported inputs

Conservative working capital /capital expenditure

Economic / industry changes or uncertainty

Change in management

Other

What Drives Value?

- **The more cash flows are adjusted for risk (probability) the lower the discount rate needs to be**

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What Drives Value?

- **Summary**
  - **Understand the terms of value**
  - **Value is in the eye of the beholder**
  - **Increase maintainable after-tax discretionary cash flow**
  - **Decrease risk**

Valuation Principles

Principle #1

Value is determined at a specific point in time

Valuation Principles

Principle #2

Value is prospective

Valuation Principles

Principle #3

The market dictates the appropriate rate of return

Valuation Principles

Principle #4

The higher the underlying net tangible asset value base, the higher the going-concern value

Valuation Principles

Principle #5

Two distinct components: (i) commercial value; and (ii) non-commercial value

Valuation Principles

Principle #6

Value is influenced by liquidity

Valuation Principles

Principle #7

The value of a minority interest may be worth less than a value of a controlling interest

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Basic Approaches

- **Two Approaches**
  - **Liquidation approach**
  - **Going concern approach**

Basic Approaches

- **Liquidation approach**
  - » **Used if not a going concern**
  - » **Net asset value less latent taxes and disposition costs**

Basic Approaches

- **Going concern approach**
  - **Asset based**
  - **Income based**
  - **Market based**

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Basic Approaches

- Asset based approach
  - Company isn't generating sufficient return on its assets to justify intangible value
  - Value = net asset value
  - Many smaller or unprofitable public companies are valued on this basis

Basic Approaches

- Asset based approach
  - Strengths / Weaknesses
    - Simple
    - Easy to understand
    - Doesn't rely on assumptions / inputs
    - Doesn't capture future value!

Basic Approaches

- **Income based approach**
  - **Discounted cash flow**
  - **Capitalized**
    - **Earnings**
    - **EBITDA**

Basic Approaches

- **Income based approach**
  - **Involves**
    - **Determining cash flow / earnings/ EBITDA**
    - **Building up discount rate or capitalization rate**
    - **Discounting cash flows back**
    - **Capitalizing earnings etc**

Basic Approaches

- Income based approach
  - Strengths / Weaknesses
    - » Captures future value
    - » Relatively easy to use
    - » Relies on inputs and assumptions
    - » Building up discount rate or capitalization rate requires some skill

Basic Approaches

- Market based approach
  - Involves
    - Determining cash flow / earnings/ EBITDA
    - Referencing multiples of other comparable companies
    - Multiplying CF / earnings / EBITDA by the observed multiple

Basic Approaches

- Market based approach
  - Strengths / Weaknesses
    - Easy to use and abuse
    - No truly comparable companies
    - Should only be used in conjunction with another approach

Basic Approaches

- Market based approach
  - Examples of misuse
    - Use of P/E multiples
    - No consideration of characteristics of “comparable” companies

The Solution

- **Consider all three approaches**
  - **Asset approach – sets the lower limit**
  - **Income approach – represents future value**
  - **Market approach - used to get comfort on whether the answer is**
    - **1st – Plausible**
    - **2nd – Supportable**
    - **3rd – Reasonable**

The Solution

- Example
  - Net assets = $5 million
  - Income approach using DCF = EV of $8 million to $10 million
  - Implies EV/EBITDA of 8x to 10x
  - Market approach (somewhat comparable companies report NTM EV/EBITDA multiples of 10x to 12x)
  - Reasonable given size, market, diversification, etc.

Thank you … Stay tuned for Part 2!