COMPANY VALUATION

A workshop for professional Management Company Owners and Brokers

33rd® company
Property Management

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ACADEMIC MATERIALS POLICY
NON-RETRIBUTION / NON-RETALIATION

DISCLAIMER – The information presented in this workshop represent Company Valuation and Cash flow analysis concepts that can help individual BROKER and OWNER practitioners gain insight into ways they can analyze and value their business and cash flows.

The information is provided in a conceptual and illustrative format in support of academic freedom where new and sometimes controversial perspectives are presented in the interest of furthering debate on key issues. The ideas and methods discussed are for ACADEMIC discussion and are not NARPM® endorsed.

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REAL ESTATE IS WHY WE ARE HERE

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Harry Sonneborn, another fast food executive, pushed McDonalds Founder Roy Kroc towards a more lucrative goal:

"You're not in the hamburger business, you're in the real estate business," *Kroc is told.*

WALL STREET IN A NUT SHELL (BIG SHORT)

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VALUE & VALUATION

- Valuation is a process to determine the economic value of a business or company.
- Valuation reflects the performance of a company (both past and future).
- The VALUE of a business to a Seller is different than the Value to a Buyer. So both Buyer and Sellers need tools to determine Value, and these Values will always be different until a final agreement is reached.

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Many Methods, but only two Approaches:

Intrinsic Value – Actual Cash flow expected over the life of the company.

Relative Value – Assets are valued by comparing them to similar assets already priced in the marketplace.

No different than how properties can be valued – Commercial is generally valued thru Cap Rates (Intrinsic), Residential generally thru Comps (Relative).

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VALUE- FROM CASH FLOW

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The value of a going concern is related to the present value of the future stream of Earnings.

EBITDA – Earnings before Interest Taxes, Depreciation and Amortization.

Free Cash Flow - Unencumbered Cash Flow AFTER Interest, Tax, and required capital expenditures. Free cash flow then is the net discretionary Earnings left to the Owner: i.e. excess earnings, owner health care coverage, paid company distributions (S Corp), Company Car, Mixed Personal Business Travel, Excess Owner Salaries, personal use portion of **mixed expenses, etc.**

Owner Benefits include: (1) Benefits you will lose in a sale, (2) Costs you will KEEP after Sale.

CAPITALIZATION OF EARNING METHOD

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Value = Annual Average Expected Earnings / (Capitalization Rate)

Capitalization Rate = discount rate (d) – growth rate (g)

Example: Your company has $100K annual profit (EBITDA). The 10 Year T-Bill rate is 3% (risk free capitalization rate).

Value = $100K / 3% = $3.3Mil

So, if you had $3.3M invested in 10 Year T-bills (risk free) you would have the same before tax rate of return as your "risk free" EBITDA.

But – your company cash flow is affected by **risk**. The Capitalization rate really should be the discount rate (k) minus the growth rate (g), and this would be something like 25% - 5% = 20%.

So Value = $100K / (25% - 5%) = $500K

MARKET BASED VALUATIONS

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Simply the comparison of one company against other similar companies in the same industry peer group.

Comparable Valuation Method or Multiple Valuation

EBITDA - Multiple Valuation

Earnings before Interest, Taxes, Depreciation and Amortization

Company P&L	Escalation Rate	Actual 2015	2016	2017
Gross Income (all sources)		$ 9,000,000	$ 9,500,000	$ 10,000,000
COGS (Rental Expenses, Rent Distributions, Maintenance expenses, etc)		$ 7,500,000	$ 8,000,000	$ 8,500,000
Gross Profit		$ 1,500,000	$ 1,500,000	$ 1,500,000
All Company Expenses (Labor, Auto, Education, Office, etc.)		$ 1,400,000	$ 1,350,000	$ 1,300,000
Net Income		$ 100,000	$ 150,000	$ 200,000
Add Backs				
Interest		$ -	$ -	$ -
Depreciation		$ -	$ -	$ -
Amortization		$ 2,000	$ 2,000	$ 2,000
Meals (Personal)		$ 5,000	$ 5,000	$ 5,000
Auto (Personal)		$ 6,000	$ 6,000	$ 6,000
Travel (Personal)		$ 10,000	$ 10,000	$ 10,000
Excess Owner Earnings/Salary		$ 9,000	$ 9,000	$ 9,000
Excess Owner Comp		$ 8,000	$ 8,000	$ 8,000
Reduction of costs upon sale		$ 10,000	$ 10,000	$ 10,000
Etc.		$ -	$ -	$ -
Total Add Backs		$ 50,000	$ 50,000	$ 50,000
EBITDA		**$ 150,000**	**$ 200,000**	**$ 250,000**
3 Year Average of EBITDA			$ 200,000	
Multiple Valuation Method			$ 200,000	
Multiple**			x5	
Total Company Value			**$ 1,000,000**	

**Current Industry Range 3-5

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Why Ratio/Multiple Valuation methods are bad for the SELLER.

Because it does not weigh all the inputs included in a DCF model, **ratio-based valuation acts more like a beauty contest: company values are compared to each other rather than judged on intrinsic value.**

Wall Street has already decided what they want to pay, and what they want to buy – so in many cases they don't care about intrinsic value, they will just walk the beach for shells.

If the companies used as comparisons are all underpriced (or overpriced) , the owner can end up selling below actual value. A well-designed DCF model should, by contrast, give sellers a better glimpse of actual value, and not just relative value.

TYPICAL ENTERPRISE VALUATION MULTIPLES

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	A	B	C	D	
1	**Date updated:**	5-Jan-17			
2	**Created by:**	Aswath Damodaran, adamodar@stern.nyu.edu			
3	**What is this data?**	Enterprise value multiples			
4	**Home Page:**	http://www.damodaran.com			
5	**Data website:**	http://www.stern.nyu.edu/~adamodar/New_Home_Page/data.html			
6	**Companies in each industry:**	http://www.stern.nyu.edu/~adamodar/pc/datasets/indname.xls			
7	**Variable definitions:**	http://www.stern.nyu.edu/~adamodar/New_Home_Page/datafile/variable.htm			
8				*Only positive EBITDA firms*	
9	***Industry Name***	***Number of firms***	***EV/EBITDAR&D***	**EV/EBITDA**	**EV**
10	Advertising	40	8.34	8.35	1
11	Aerospace/Defense	87	11.10	13.96	1
12	Air Transport	17	6.54	6.56	1
13	Apparel	51	10.84	10.97	1
14	Auto & Truck	18	7.45	10.62	3
15	Auto Parts	62	5.97	7.59	1
16	Bank (Money Center)	11	NA	NA	
17	Banks (Regional)	612	NA	NA	
18	Beverage (Alcoholic)	28	17.26	17.26	2
19	Beverage (Soft)	35	17.44	17.92	2
20	Broadcasting	27	9.18	9.19	1
21	Brokerage & Investment Banking	42	NA	NA	
22	Building Materials	39	12.17	12.80	1
23	Business & Consumer Services	169	12.16	12.40	1
24	Cable TV	14	9.66	9.68	1
25	Chemical (Basic)	38	9.34	9.67	1
26					
27	Publishing & Newspapers	41	7.94	8.02	1
28	R.E.I.T.	244	20.78	20.79	4
29	Real Estate (Development)	20	28.92	28.92	6
30	Real Estate (General/Diversified)	10	11.96	11.96	2
31	Real Estate (Operations & Services)	60	13.95	14.08	2
32	Recreation	70	10.01	11.68	1
33	Reinsurance	3	14.25	14.25	1
34	Restaurant/Dining	81	13.83	13.84	2

http://people.stern.nyu.edu/adamodar/New_Home_Page/datafile/vebitda.html

CHART

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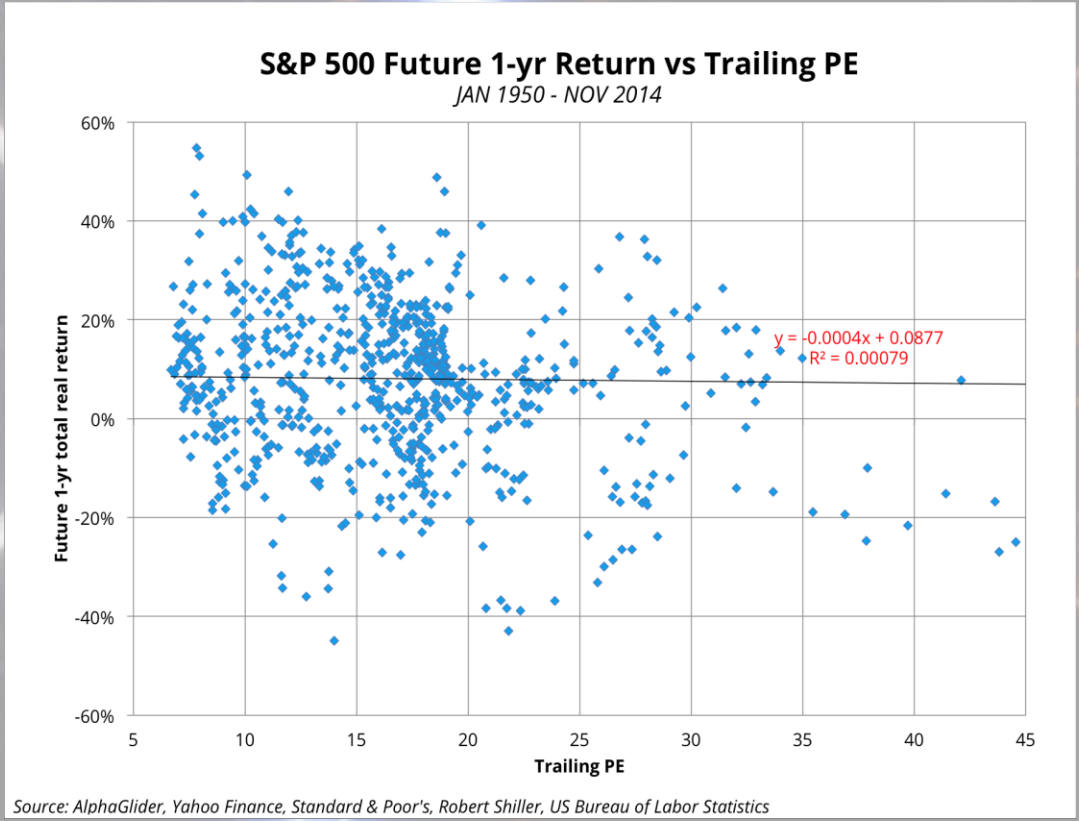

DISCOUNTED FREE CASH FLOW METHOD

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Future annual Cash Flows are estimated, and then discounted to present value using the discount rate (time value of money). Terminal value is the Annual Average Future Cash Flow estimate (typically year 5 to 10) discounted to present value.

$$PV = CF1 / (1+k)^{1} + CF2 / (1+k)^{2} + \ldots [TCF / (k - g)] / (1+k)^{n-1}$$

Note: if you use free cash flows which add back non-required expenditures to EBITDA (i.e. perks), then **business owners typically discover that their company value is much higher to them than to a Buyer.**

DISCOUNTED FREE CASH FLOW METHOD

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DISCOUNT RATE (k) – is the riskiness of the cash flow and business and is the same as the Weighted Average Cost of Capital (WACC)

$$WACC = \frac{(Kd \times D) + (Ke \times E)}{(D + E)}$$

LETTER MEANING:

D = Debt part of Capital Structure
E = Equity part of capital Structure
Kd = Cost of Debt (post tax)
Ke = Cost of Equity

For an established mature Property Management Company, the discount rate is generally 20 – 25%. 5-10 Year company maybe 25% to 30%, start-up 35%+.

DISCOUNTED FREE CASH FLOW METHOD

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DISCOUNT RATE (k) – Some Perspective

	YEAR 1	YEAR 2	YEAR 3	YEAR 5+	YEAR 10+
Risk Group	Seeking Money	Seeking Money	Early Startup	Late Startup	Mature
Risk Rate	50%-100%	40%-60%	40%-60%	30%-50%	10%-25%
Discount Rate	**50%**	**45%**	**40%**	**30%-35%**	**20%-25%**

GROWTH RATE (g) – Pure Estimate | Organic growth in the 5 – 10% range.

Property Management is in an industry consolidation phase, but still growing. Acquisitions are not organic growth (Wall Street does not see the difference).

DISCOUNTED FREE CASH FLOW METHOD

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The Discounted Free Cash Flow Model - Business Valuation

YOUR COMPANY - PV FCF (Present Value of Free Future Cash Flows)

		Years Ending December 31										
	FCF Growth Rate	Actual			Forecast							
FREE CASH FLOW DESCRIPTION**	0.00%	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Excess Owner Salary	0.00%	$40,980	$44,620	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000
Child Salary #1	0.00%	$40,000	$59,679	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000
Child Salary #2	0.00%	$5,000	$24,829	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000
Distributions (If taken this is actual cash flow)	0.00%	$10,000	$10,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000	$40,000
Property Mgmt Services (Owned Properties /current Rates	0.00%	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000
Health Care Premuims (Owner)	0.00%	$10,000	$15,058	$15,000	$15,000	$15,000	$15,000	$15,000	$15,000	$15,000	$15,000	$15,000
Personal/License/Travel - Owner	0.00%	$20,000	$40,000	$41,000	$41,000	$41,000	$41,000	$41,000	$41,000	$41,000	$41,000	$41,000
Other Soft Compensation (i.e. NARPM LIFE Membership)	0.00%	$19,020	$814	$94,000	$94,000	$94,000	$94,000	$94,000	$94,000	$94,000	$94,000	$94,000
Free Cash Flow		$150,000	$200,000	$250,000	$250,000	$250,000	$250,000	$250,000	$250,000	$250,000	$250,000	$250,000
Discount Rate (k)	20.00%											
LT Growth Rate (g)	3.59%											
Number of Periods (n)	8			0	1	2	3	4	5	6	7	8
Present Value of Free Cash Flows	PV				$208,333	$173,611	$144,676	$120,563	$100,469	$83,724	$69,770	$58,142
Terminal value, Year 8												98,852
Present Value of Free Cash Flows (SUM Year 1-7))		$901,148	(Year 1-7)									
Terminal Value (@ Year 8)		98,852										
Total Present Value of Free Cash Flow		$1,000,000										

$$PV = CF_1 / (1+k) + CF_2 / (1+k)^2 + \ldots [TCF / (k - g)] / (1+k)^{n-1}$$

** Income you are going to lose, or Costs you are going to KEEP incurring after you sell

DCF PROS AND CONS

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DCF of Free Cash Flows is a better tool Predicting Operating Cash Flow Projections

- Provides a better idea of the level of earnings that is really available to a firm after it meets its interest, tax, and other commitments.
- Capital Expenditure Projections – Effect on Free Cash Flows
- Discount Rate / Growth Rate makes a big difference.

REPACKAGED FISH- BIG SHORT

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LOANS- BIG SHORT

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PROPERTY MANAGEMENT IS THE KEY

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Property Management is the operation
that supports the real estate.

BUY SOME,
and leverage this benefit for your business.

DCF VS. MULTIPLE

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Multiples are really just a simplified rule of thumb version of DCF. All of the variables of business value are incorporated in both techniques, but are simplified and generalized when using multiples whereas they are explicitly estimated with DCF.

As indicated in this presentation, it is more important to estimate and analyze valuation drivers than it is to let the multiple do that important work.

BUYER RED FLAGS

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Buyer views you as “Just a Number” – due diligence only focuses on financials, no concern for employee bio’s, growth, reputation, longevity of client, quality of doors, turnover rates, strategic position in local market, etc.

Local competitor offer – they only want the doors, not the company. You will be low balled for a purchase of doors.

Avoid Buyers only using a single valuation model, especially if they only use an earnings multiple. Have them show you their math. Add back missing free cash flow items that are not in the EBITDA.

If asked if you have an “Assignment Clause” it is a tip off that your are being shopped only for doors, and not for your company.

Ask why the Buyer is interested, and what is the purpose of the acquisition. Good buyers are looking for acquisitions based on adding another product offering, expanding reach, leveraging their base, adding missing strengths or brand to their portfolio.

BUYER RED FLAGS

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MBA How to buy a business course (www.ardenbay.com)

The buyer NEVER sets up a visit to your company to meet with you personally or discuss your business– HUGE Red Flag.

All the due diligence is financial, not regulatory (i.e. trademarks, licenses, employee credentials, etc.), SWOT, or other attributes.

The only legal question that is asked is “Do your contracts contain an “assignment clause” – i.e. **you are being shopped for doors.**

Dis-allowed add backs to EBITDA for paid distributions or dividends, perks, or other soft compensation – they have already socialized the 3-7X multiple, so the incentive is to deny EBITDA add backs for soft compensation, and then say OK we will use the higher multiple. The is the BID, not the ASK.

Stating up-front that they would like to get an LOI stating a multiple of 5-7. (Trying to lock in a multiple valuation range first, even before they know your company).

DON’T SELL YOUR LIFE’S WORK AT A DISCOUNT

30 DAYS TO BETTER CASH FLOW

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- Fire your worst employee & reallocate work to other employees.
- Renegotiate a cloud service
- Renegotiate 2 services (i.e. internet or phone).
- Cancel 2 subscriptions your may well not need or be using
- Review your Corporate Credit card and cancel 2 service providers
- Find a solution for a better service/product and REPLACE this vendor.
- ADD UP THE MONTHLY SAVINGS, in perpetuity, and calculate the value.

YOU WILL BE AMAZED!!

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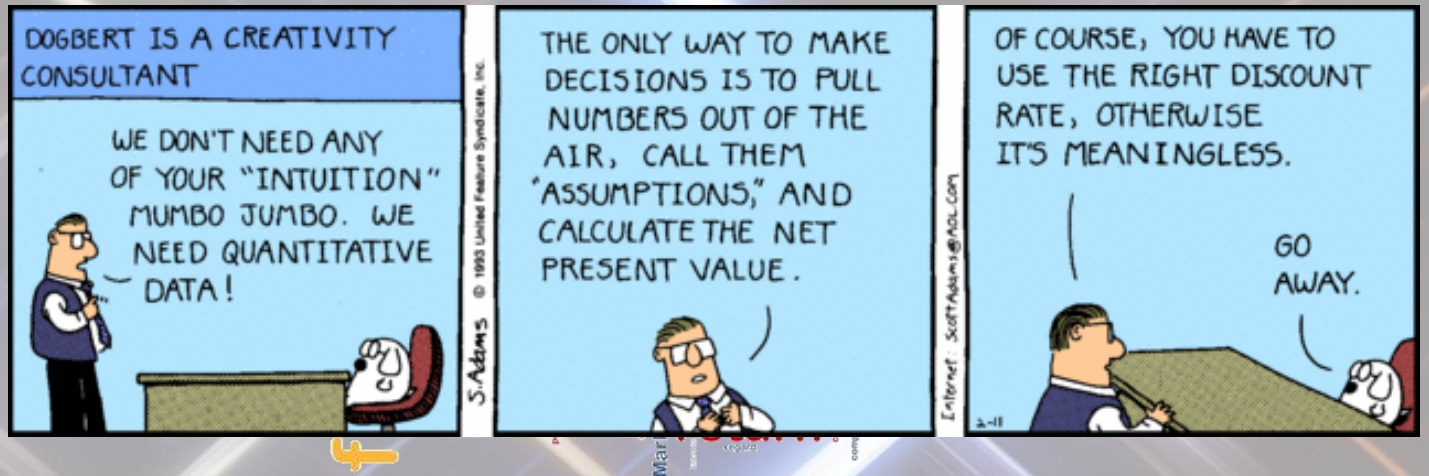

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