



# WHAT'S IT WORTH?

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*For Business Owners, Corporate Officers, & Their Advisors*

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## A Venture Capitalist's View of Value

*Submitted by David Moser, ASA, CEI*

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Valuation influences many management decisions. For instance, an owner may need to know the value of his or her business to raise capital or to react to an unexpected bid from a competitor. Valuation is also important in acquisitions, joint ventures, strategic investments or new business opportunities. Here are some valuation factors management has to consider in any major business move.

### A Position of Strength

The key issue is to develop a model that accurately reflects the underlying elements of the business. To do this, a valuation professional needs to create robust financial projections, select appropriate valuation methodologies, determine the parameters (such as discount rates or other variables) and then compare valuation ranges with similar companies.

After the valuation range has been determined, an owner will be in a much stronger position to negotiate with potential investors. Potential acquirers or investors typically develop their own forecasts and create their own valuation models. Investors are always seeking "undervalued" companies that offer an opportunity to improve earnings. They focus on the company's earnings potential, management capabilities and competitive advantage. It is therefore important to develop detailed financial projections.

### Other Important Issues

Another important issue is whether earnings over the invested capital will exceed or fall short of the cost of capital. We calculate the cost of capital by adding the cost of equity and the after-tax cost of debt in their respective proportions. Although the cost of capital calculation has been simplified, it is actually known as the weighted average cost of capital. If, for example, the return on invested capital is less than the cost of capital, the company is unlikely to generate sufficient cash to stay in business. The time to break even is a critical consideration. On the other hand, if the return on investment is in line with the cost of capital, then the company is at least

profitable, although it may not be generating the level of returns required by investors.

Obviously, the company may not yet be sustainable and may have some difficulty attracting investors, who may be more interested if the returns on investment exceed the cost of capital. Venture capital managers seek to achieve returns of 25% and above on their investments.

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Earnings sustainability is a key consideration and is driven by strong competitive advantage. Capital will always flow toward sustainable companies with improving earnings. Some time ago, the buy/hold/sell recommendations of various brokers for listed information technology companies were reviewed. The companies with strong earnings rates, expressed as earnings before interest, taxes, depreciation and amortization (EBITDA) to sales greater than 20%, clearly had “buy” recommendations.

### The Appropriate Valuation Method

Once a valuator has developed financial projections and considered different scenarios, he or she needs to determine the most appropriate valuation methodology, taking into consideration the investment stage (seed, start-up, early or late expansion, bridge funding) and the proposed exit form (IPO or trade sale). The valuator also looks at company-specific factors such as revenue growth, margins and return-on-investment rates. Generally, two main valuation approaches work best from a venture capitalist's viewpoint.



1. **Capitalization of earnings.** The capitalization of future earnings approach is based on using an appropriate multiple and applying that to the projected earnings. This approach is fairly widely used in both the public and unlisted markets and is easy to understand. But some difficulties may arise in calculating “maintainable” earnings and the selection of appropriate multiples. Is it a price earnings multiple, an EBIT or EBITDA multiple, or a cash flow multiple?

For example, if the price earnings multiple is used, the calculation is: the price earnings multiple by the net profit after-tax figure. So if the company is trading at a price earnings multiple of 10 and has a net profit after tax of \$5 million, the implied valuation of the business is \$50 million (assuming no debt). This valuation method is generally not suitable for companies in the seed, start-up or early development stages. It is also inappropriate for “turnarounds” or badly performing companies.

A potential investor is usually very interested in the selection of the multiple and earnings estimates. If the multiple increases and the earnings grow, a “double whammy effect” may occur. Two separate factors are working together to provide an uplift in the valuation. Venture capital managers are keenly aware of this dynamic. Essentially, they want to buy low (with low multiples) and add value (by boosting earnings) on the way through.

2. **Discounted cash flow.** Valuations typically use the discounted cash flow approach to value companies, acquisitions or investment opportunities for which cash flows (amount and timing) are available. This approach also is appropriate for companies in the early development stages, companies with lumpy cash flows or companies seeking to break even in the near future.

The financial projections flow into the discounted cash flow model. The problematic issues for this approach relate to selecting the discount rate and calculating the terminal value at the end of the forecast period. Depending on the stage of the investment (seed, start-up, early or late expansion, or bridge), different discount rates reflecting the business risk apply. A liquidity premium is also included in the discount rate to reflect the illiquid nature of unlisted companies.

The terminal value, depending on the future earnings potential of the business, may represent a significant part of the valuation, which reflects valuation of earnings from current and future activities. Valuers usually calculate this value as of the end of the forecast period by using the capitalization of earnings approach and then discounting back the amount.

After the valuator applies the appropriate valuation methodology to the forecast numbers and derives a valuation range, he or she should check the numbers against the valuations of comparable companies with similar economic characteristics (size, growth rates, profitability, capital intensity and risk).

### Better Decisions

Developing the necessary projections and establishing a valuation model may seem costly or time-consuming, but your clients can make better business decisions if they understand its benefits. Whether raising capital, negotiating a sale, or evaluating future acquisitions or other investments, an awareness of the business's value is key. Please call with any questions you or your clients have regarding the relationship of value to these decisions. We would be glad to advise you.

### Sidebar: Projecting the Future

Financial projections can help determine whether a business is an appropriate to divide the projections into two periods: the first five years and the second five years. Projections are required for a period of up to 10 years. Because assumptions may change as a result of industry factors as well as the particular competitors, suppliers and buyers, it may be appropriate to divide the projections into two periods: the first five years and the second five years.



*Do you own a business or advise a business owner? Contact Dave Moser to arrange a free valuation consultation.*

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## Meet the Valuation and Transaction Services Group

*By: Dave Moser, Director Valuation & Transaction Services*

I hope you have enjoyed our complimentary newsletter. **If you would like to add a client or friend to the distribution list, or join our monthly e-mail newsletter, please e-mail: [dmoser@coulterjustus.com](mailto:dmoser@coulterjustus.com)** with "Subscribe" as the subject.

Our Valuation and Transaction Services team has over 60 years of combined experience involving more than 1,000 projects, and continues to be the largest and most experienced full time valuation group in East Tennessee. We understand the significant financial and emotional impact our services play in client's lives, and are excited to offer a full range of transactions services.

In addition to business valuations throughout North America and Internationally, we provide M&A advisory services for substantial private firms, as well as a host of real estate advisory services including: cost segregation studies, real property tax appeals, lease audit and negotiation, and feasibility analysis.

### David G. Moser, ASA, CEI

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David is a certified member of the American Society of Appraisers (ASA) and has over 34 years experience in the valuation profession. Before joining Coulter & Justus in 1996, he served as partner and director in charge of valuation with Ernst and Young and in management positions with two other international valuation firms. He has considerable experience in valuations, cost segregation studies, and as an expert witness.

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Renee joined Coulter & Justus in 1999 and has over ten years of business valuation experience. She has valued businesses for purposes including mergers, estate tax and gifting, litigation, bankruptcy reorganization, and in performing cost segregation analysis. Renee also has troubled business turnaround and controllership experience in addition to tax and audit experience.

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Having closed several hundred thousand feet of real estate deals, Chris specializes in commercial real estate consulting, appealing real property tax assessments, and business valuation. Chris holds an MBA from the University of Notre Dame Mendoza School of Business, as well as the CCIM (Certified Commercial Investment Member) designation, and AVA (Accredited Valuation Analyst) designation.

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Sven has over 14 years experience in investment banking and business valuation, including mergers and acquisitions. He joined Coulter & Justus in 2003 and has an MBA with an emphasis in Finance from New York University's Stern School of Business and also holds the CM&AA (Certified Merger & Acquisition Advisor) designation.

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Cindy has over 14 years client service experience in the areas of auditing, budgeting, and finance as well as general business consulting. She joined Coulter & Justus in 1997 as a Business Valuation Consultant.

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