Real **Shareholder Value??=*Real Deal* Required**

Tony Wayne CVA, CPA, CIRA, CFF
IronHorse LLC
January 9, 2022
www.ihorsellc.com
https://www.linkedin.com/in/tony-wayne-13b92b/
(913) 568-6370; twayne@ihorsellc.com

 

Baker: "Deal, Jayhawks?"

Jayhawks: "No deal, no dice, Baker. Rock Chalk."

First off, a great big happy 2022 to all!! Here is to truly hoping the coming year is healthy, hopeful, happy and productive for us all. Never in a thousand years would any of us have sat here January 2020 and envisioned the path forward for the next 24 months. And for sure, no valuation modeling output completed back then placed measurable probability (if any) on the macro-economic, industry and served market scenarios all of us have dealt with since then, not to mention for many just simply staying alive and keeping the doors open. Literally.

On a positive side, the pandemic gave IronHorse the opportunity to rethink and refocus our primary business targets. We've completely exited the turnaround consulting, investment banking, and CFO and due diligence business offerings.

Simple is beautiful and a tighter focus means we can concentrate our energies, our engagements to leverage our expertise and **offer _highly tailored solutions focused on value:_**

- It's measurement.
- Allegations of intentional distortion in reporting it, unauthorized dissipations involving it.
- Disputes and disagreements involving it.
- Creation, building, aligning, sharing and harvesting of it.
- Pledging and preserving it.
- Early warning indicators of its potential impairment-how to prevent/avoid and strategies to manage if/when it occurs.

When rendering an expert opinion on fair market value ("FMV") of an enterprise, the underlying assumption is of a ***hypothetical transaction***, involving a willing seller and buyer, each under no compulsion to enter into a transaction. Fair value ("FV") on the other hand introduces the notion of ***likely transactions***, likely transaction participants. This sounds very similar on the surface, but depending on the engagement requirements and the particulars, the value inference can indeed be quite different between the two approaches. Moreover, the valuation estimation process can be further complicated if called on to measure intangible asset value and its impairment, solvency of the enterprise, net orderly liquidation value estimates, controlling vs. non-controlling interests, etc.

There is one and only one sure-fire certain process to determine the going concern value of a privately-held enterprise; conduct a very thorough, exhaustive, orderly investment banking process to create a "market" for the business. The participants will vote with their pocket books and depending upon the degree of competitive interest/tension that results, you'll nail down that number we all try so hard to estimate.

Word of Caution to the Wise-Owner Beware

The pandemic has impacted us in so many ways, not the least of which between our collective ears.

Have we not all gained such a keen appreciation for how precious our health, but also our time is? We don't possess an unlimited supply of both, but more importantly how quickly it can fly by and at some level, how little control we have of either one of them. For quite a while now we've known the clock was ticking on us Boomers and that 80 million or so would be saying sayonara to the workforce and our businesses. But, the pandemic has caused an unprecedented and much faster exit than we saw coming even two years ago. We've stepped hard on the gas pedal and have accelerated the pace at which the exits have and most definitely will occur over the next decade. There are estimates of in excess of 12 million Baby Boomer business owners who may be exiting over the next decade or so.

However and in spite of the rapidly growing exit planning industry over the past 10-12 years, unfortunately for so many owners they still have not prioritized this critical process and as a result, "disorderly" exits may still remain problematic for them:

https://www.business-money.com/announcements/the-entrepreneur-wars-baby-boomers-vs-millennials/

> *However, age is becoming an increasingly worrying problem for baby boomers, with the youngest of this generation now entering their sixties.* ***72% of baby boomer business owners confess that they have no exit strategy for their business****, signaling a growing anxiety about who is going to take over the economic workforce.*

Our valuation practice engagement volume is most definitely driven by litigation, value distress and impairment, and pledged collateral crises. Disagreements that involve and impact value, but also situations where the carving up and sharing of it arise; commercial credit defaults, divorces, ownership disposition disputes, and transactional deals that go south. You know, the various scenarios that get little to no measurable probability weighting within the very models used to fund these enterprises originally. And far too often, it is situations involving unplanned, unexpected crises and interruptions that lead to an initial valuation of the firm, and a "harvesting" of that value under duress.

This paper is most <u>certainly not intended</u> to indict the exit planning process and those who strive to assist ownership in avoiding exit liquidity events under stressed conditions. On the contrary, there most clearly remains a need going unfulfilled and vast numbers (and growing) of owners who have yet to prioritize this critical process. Unplanned, disorderly exits certainly don't maximize value and shareholder returns. But the pandemic has opened the eyes of us grizzled veterans and a growing number of professionals are trying to seize this momentum to "coach" these owners about shareholder value and how to measure, monitor and accelerate its growth.

Far too often, we've found ourselves trying to assist clients at times of crises when it becomes clear to us that at the heart of the problem was a definite failure of "knowing what question to ask". Frequently, this arises because they find themselves too tempted to not remain and continue to play in their "own sandbox". They're consumed, going 100 different directions, they lack patience and as a result they become impulsive in their decision making.

In particular and especially when deciding upon who to saddle up with as a "value coach".

The Commoditization of Value Modeling & "Coaching"-Caveat Emptor For Sure

Successfully closed merger and acquisition ("M & A") deals are really the only way to confirm enterprise value via an arms-length, fair and objective investment banking (" I-Bank") process. Truly, that's it and every other attempt at quantifying some inference of firm value involves estimation. And, there truly is no one size fits all when attempting to estimate that value:

- Purpose of the value drives the required approach.
- Formal opinions of value should be performed by those with the requisite credentials including certifications that mandate professional standards be followed.
- Calculations of estimated enterprise value inferences should also be done by qualified, credentialed experts but typically the standards allow for more flexibility in approach and deliverables.
- Differing industries, served-markets and specific subject company variables can also influence the value modeling approach.

As an experienced retained testifying expert, years ago I was exposed to the critical priority and importance of "staying/playing within my own sandbox"; translation=stick tightly to what you know and avoid what you don't. Oh man, oh man can that be a tough lesson to learn and adhere to when you're building your business and competing for engagements. But, woe be to the valuation professional who opts not to adhere to that brutally cold reality. All it takes is for one case outside of our wheelhouse to spin us into a Daubert exposure, to blow a relationship(s) within our referral network, but most importantly to not provide the solutions resources our client needs from us.

I've been involved in business valuation for most of the past two decades; much if not most involving transactions of some sort. Literally, I've worked with deal participants in hundreds of transactions and their aftermath. We are, in effect, small middle market, small market <u>*bad deal experts.*</u> Until roughly a year ago, an important piece of our service offering included both special situation investment banking as well as buy and sell side deal due diligence consulting. We understand and have experienced a plethora of transactions involving questions of value; secured commercial loans and administration, liquidations, capital raising and infusions, family law proceedings, divestitures and most definitely litigation where core differences/disputes are focused on value.

However…………

My over-riding purpose in this paper is to caution and alert business owners beginning to contemplate and entertain the prospects of engaging a professional to coach them through the valuation calculation, building and exit preparation process; this service offering is starting to rapidly fill up with *professionals with* ***very little to no*** *exit and liquidity deal event experience*, but more importantly no hands own demonstrated expertise in building and harvesting that value within the industry and firm specific context of the business you've spent your entire adult life treating as your "first born". They don't know deals, they don't know your industry and niche, and they've never sat in your chair and implemented the things they'll say you need to build.

In essence, *they're being sold* by software developers to lease licenses to their products, while "coaching" them on *how to sell you* on how simple and easy it is to put a number to your enterprise value, to calculate specific dollar amounts to very generalized notions of value building opportunities/priorities, and doing all of this while claiming the engine that drives all this is proprietary but "validated," and highly relevant to the uniqueness of your first-born.

Bottom line is ***you*** *need to due diligence* your due diligence preparation coaches.

Knowing What Question(s) to Ask

First off, if the pitch you hear suggests a quick 2-minute highly generalized questionnaire to put a number on your enterprise value and potential value, a ten minute or so conversation, followed up with a couple hours to drill way down into the critical value priority variables, and then a few hours with you/your team to unveil the plan on how to maximize the value of the firm you've devoted your life to, maybe give some thought to there just might be a bit more to the transactional preparation, the due diligence readiness assessment than just that. In particular and especially if the prospective coach might be light in the deal making loafers, and has little to no first hand, hands-on experience within your niche.

And……

If the prospective coach also suggests their software has identified and statistically validated the 18 most critical value priority areas of focus (or the 8 critical value levers to pull) within your industry and served market, that they also have that same data on how your competition stacks up on these, they have computed how your firm compares to your competition, and most importantly they have a hard number on the value upside you can realize by closing your most critical value disparities at the discrete and granular hole level, ***then make them lift up the hood, expose what's underneath and prove to your satisfaction they can support their contentions***.

Although they will likely assert their "robust" model is proprietary, highly exclusive/valuable/confidential intellectual property, (but statistically validated), a critical assumption that demands being challenged by you is that indeed they have sufficient and verifiable comparable data at the value "driver" or "lever" level and can accurately, confidently project the enterprise value impact by "closing" the value holes ***they say*** you should prioritize. Again, all based on very general responses to very subjective, generalized questions you respond to.

It's pretty straight-forward to seek out "comps" in many if not most residential real estate transactions in suburban U.S.A. In many cases, the subject property in question is virtually identical to dozens that have closed in recent transaction sales. Ditto commercial office buildings, retail properties, and industrial properties. Liquidation values for common manufacturing and industrial equipment and vehicles are pretty easy to find. Re-sale and trade-in values for automobiles are readily available.

Comparable business transaction data at a detailed financial and operating level not so much, as those of us who do business valuation for a living can attest to. Private equity and venture capital firms know that coming with an offer price is one part science, but a lot of subjective art and feel as well. Moreover, those firms with similar assets/investments in your space spend a great deal of effort determining what *strategic business combination value* a deal might generate.

One of those offering value coaching software modeling, commonly refers to firms generating $ 2-3 million in top-line revenue as "middle market". That's absolutely <u>no</u>t how most categorize firms of that size, but more importantly the marketability of firms with revenues under $ 8-10 million is <u>extremely challenging</u>. Typically and unless a P.E firm is looking to make bolt-on additions to an existing portfolio concentration, these firms tend to avoid small deals. One big reason is even though a company may be small in size, there are practical limits on the number of companies a firm wants to invest in. Our experience in attempting to market small deals tells us that in many if not most cases, these transactions are much tougher to generate interest, competitive tension and a closed deal that satisfies the requirements of the buyer as well as the return objective of the business owner.

An experienced, qualified value coach should recognize this substantial hurdle right from the get go and on the front-end. Gotta be willing to tell your client what they don't want to hear, provide a reality/gut check to the practical realities of executing a small exit transaction. Especially if the firm is underperforming, or has high concentration of revenues, relatively small number of customers, intense competition, and/or 1-2 huge players who dominate their space.

Ample, verifiable, comparable and detailed transaction data is extremely challenging to obtain and validate. It's why so many of us tasked to render FMV opinions tend to avoid using comparable transactions to value small, niche firms. Problem is there is a paucity of reported data on these deals. Indeed there are sources available we use, but the process of identifying a sufficient volume of truly comparable deals causes us to place more weight on other valuation modeling approaches.

Lastly, please probe the specific "industry" code(s) utilized in the model that drive comps, value gap estimations at the detail category levels. Be sensitive to these designations as quite often they can be at a highly summarized macro-level, or at much lower levels and correlate to SIC and NICS categories/characterizations; these may or may not be germane to your specific niche, your primary target served market space segments, or your primary competition. Also and again, make sure your value coach has shown you *specifically how the transactional and detailed comp information is being used*; volume of reported deals, deal participants, timing of the reported transactions, source(s) of the data, etc. Frequently, these aggregate firms of all sizes, public and private firms, firms with various ownership and capital structures, mature, young, etc. Most reported transactional data is highly aggregated, highly summarized and fails to reflect value attributes at the granular detail level the models purport to measure. Reported transactions include deals of all kinds; P.E. strategic combinations, divestitures, liquidations, LBOs, re-capitalizations, etc. It's critical to identify your most likely deal participant/partner, deal type, deal size to validate the model estimations.

What follows is a summary comparison of critical considerations and questions to answer to guide your decision on who to select as a value building expert-your "due diligence priorities" for selecting a due diligence preparation coach:

	PRECAUTIONARY CONSIDERATIONS/AVOID		QUESTIONS TO ASK
1	CLAIMS OF ENTERPRISE VALUE & QUANTIFICATION OF SPECIFIC, DISCRETE GRANULAR LEVEL VALUE INCREASE POTENTIAL AFTER BUT A FEW HOURS OF COMPLETING VERY GENERIC QUESTIONAIRES WITH VEY SUBJECTIVE POTENTIAL ANSWERS	A	ASK THEM TO PROVIDE DETAIL SUPPORT BEHIND THESE CALCULATIONS.
		B	EXAMINE THE UNDERLYING "COMPARABLE" TRANSACTION DETAILS FOR VALIDATION OF SOURCE, INDUSTRY, SIZE DIFFERENTIALS, FINANCIAL COMPARATIVES, VOLUME OF TRANSACTION COMPS USED
		C	PAY CLOSE ATTENTION TO CALCULATIONS OF VALUE INCREASE POTENTIAL, SOLELY FOR JUST "**DOCUMENTING**" CERTAIN ATTRIBUTES, APPROACHES, POLICIES & PROGRAMS, ETC.
2	CLAIMS OF DOLLARIZED, PERCENTAGE INCREASE IN ENTERPRISE VALUE OVER BUT A MATTER OF MONTHS SIMPLY BY WORKING WITH A PARTICULAR ADVISOR/SOFTWARE PARTNER.	A	AGAIN, YOU NEED A DETAILED, WORKING UNDERSTANDING OF THE VALUE MODEL-IT'S ASSUMPTIONS, BASIS/SUPPORT FOR COMPUTATIONS. THIS TYPE OF CLAIM SHOULD BE READILY VALIDATED BY THE PROSPECTIVE COACH-JUST AS A PROSPECTIVE BUYER OF YOUR OWN BUSINESS WOULD DO IN THEIR DUE DILIGENCE PROCESS.
3	CLAIMS MADE OF MILLIONS OF INCREASE IN BUSINESS OWNER VALUE BY WORKING WITH A PARTICULAR PROSPECTIVE COACH/THEIR SOFTWARE PARTNER.	B	DEVIL IS IN THE DETAILS OF COMPLETED TRANSACTIONS. ASK THEM TO PROVIDE DETAILS OF SUBSEQUENT TRANSACTIONS COMPLETED AFTER WORKING WITH THE ADVISER AND THEIR SYSTEM. ASK THEM TO PROVIDE BUSINESS OWNER REFERENCES FOR YOU TO COMMUNICATE WITH.
4	AVOID ENGAGING CONSULTANTS WITH MINIMAL TRANSACTION EXPERIENCE, NO DUE DILIGENCE EXPERTISE, NO I-BANKING DEAL HISTORY.	A	REQUEST DETAILED CV'S.
		B	ASK FOR REFERENCES FOR SUBSEQUENT COMPLETED TRANSACTIONS AFTER USING THEIR SYSTEM.
5	AVOID PROFESSIONALS WITH LITTLE TO NO EXPERIENCE WITHIN YOUR/SIMILAR INDUSTRY, OR ENTIRE CAREERS SPENT AS PRACTICING CPA'S.	A	VALUATIONS FOR ESTATE TAX RETURNS, ESOPS, THAT LACK TRANSACTIONAL BASIS ARE DIFFERENT ANIMALS THAN THOSE INVOLVING DEALS. ASK THEM TO DEMONSTRATE THEIR EXPERTISE IN I-BANKING, CAPITAL FORMATION, LENDING, EXITS, DUE DILIGENCE, ETC.
6	APPROACHES THAT INCLUDE BUT ONE ESTIMATION MODEL APPROACH FOR ENTERPRISE VALUE.	A	CHECK TO SEE WHAT OTHER MODELS THE PROFESSIONAL WILL USE TO ESTIMATE ENT VALUE, BESIDES THE LICENSED SOFTWARE THEY USE.
		B	INSIST THEY RECONCILE THEIR MULTI-MODEL APPROACH AND EXPLAIN WHY THERE MAY BE SIGNIFICANT DIFFERENCES BETWEEN THE ESTIMATED INFERENCES.
7	CLAIMS OF 18, 8 OR SOME OTHER HARD, FIRM PRIORITY VALUE ATTRIBUTES.	A	ASK WHY BUT 8,18 OR SOME OTHER NUMBER?
		B	HOW DID THEY COME TO THIS CONCLUSION AND ASK THEM TO PROVIDE THEIR ANALYSIS & SUPPORT FOR THE CLAIM.
		C	WHY BUT ONE PRIORITY SET FOR FIRMS IN DIFFERENT INDUSTRIES, DIFFERENT SIZES, DIFFERENT GEO LOCATIONS, DIFFERENT OWNERSHIP STRUCTURES, PRIVATE VS PUBLIC FIRMS, ETC?
8	AVOID PROFESSIONALS AND FIRMS WITH LITTLE NO EXPERIENCE IN BUILDING AND MAINTAINING VALUE ANALYTICS AT THE DEPARTMENT, WORK CENTER & OPERATING UNIT LEVEL.	A	WHAT EXPERIENCE DO THEY HAVE IN ALIGNING THE ORGANIZATIONAL UNITS TO RELEVANT VALUE CONTRIBUTORS AT A MICRO LEVEL?
		B	EXPERIENCE IN DEVELOPING AND IMPLEMENTING VALUE SHARING COMPENSATION SYSTEMS?
		C	KPI ANALYTIC SYSTEMS DEVELOPMENT/MANAGEMENT EXPERIENCE WITHIN THEIR NICHE?

Summary

Ideally, preparation for a positive exit outcome should begin years before the desired exit timing; it's hard work, it demands discipline, priority and commitment. And in many if not most cases, it does pay dividends to engage professionals who can help guide that journey to a successful, eventual deal; experienced professionals with a demonstrated, verifiable transactional track record, specific relevant industry experience and preferably at the operating level within your industry.

After all, these coaches are suggesting the "optimum" plan to maximize your exit value, so *make sure they can prove to you* they have sufficient, verifiable and demonstrated expertise at your business unit level; building and managing aligned analytical and organizational processes targeted at the most critical granular value attributes necessary to fuel enterprise value growth initiatives. So, do your homework, perform your own due diligence on your self-proclaimed value coach/due diligence experts, and trust your first-born to only those demonstrably worthy of earning that trust.

ABOUT IRONHORSE LLC

IronHorse LLC is a highly-specialized, focused business consulting firm with practice concentrations in business valuation & appraisal, expert witness services, forensic accounting, and commercial loan & private-equity compliance services.

We specialize in highly-complex financial, commercial, private placement, and M & A transaction litigation engagements. Also, we perform business appraisals and valuations for family law, estates, SBA loan applications, portfolio compliance and distressed business engagements.

Extremely tight industry concentration; manufacturing & wholesale distribution, cannabis, building materials & contractor supply, automotive after-market, and heavy duty equipment supply-chain vendors.

Primary target six-state geographical footprint including Kansas, Missouri, Nebraska & Iowa, IronHorse is an ideal fit for closely/privately held industrial firms with $ 5 million to $ 35 million in annual revenues