What You CAN Do to Enhance the Value of Your Business

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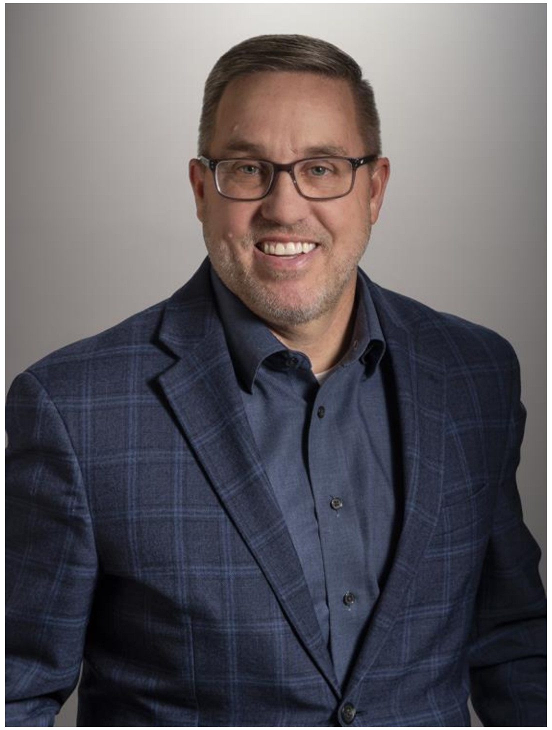
INTRODUCTION



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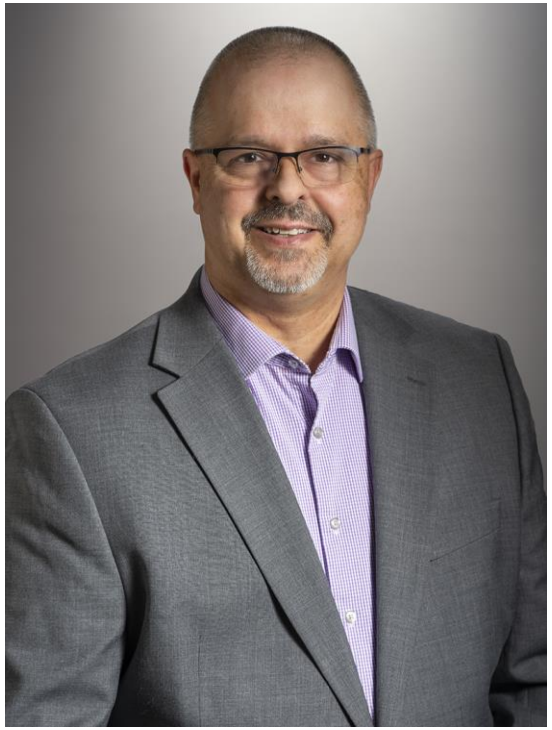

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FIRM OVERVIEW

McKonly & Asbury is a team of CPAs and Business Advisors serving clients from our offices in Camp Hill, Lancaster, and Bloomsburg.

We provide **Advisory & Business Consulting**, **Audit & Assurance**, **Entrepreneurial Support & Client Accounting**, **Internal Audit**, **Professional Placement**, **Tax**, and **Technology** services to a variety of industries including:

Affordable Housing

Construction

Employee Benefit Plans

Family-Owned Business

Healthcare

Manufacturing & Distribution

Nonprofits

AGENDA & OBJECTIVES

- Identify key areas and variables which impact value.
- Identify steps a company can proactively take to increase value.
- Gain an understanding of the impact that economic and other uncontrollable factors can have on the value of your business.

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INTRODUCTION TO BUSINESS VALUATION (BV)

INTRODUCTION TO BUSINESS VALUATION

- BV is NO different than any other investment decision.
- Three variables are considered in EVERY investment decision:
  1. The amount of **Return** (cash flow) you receive from the investment,
  2. The **Risk** of not getting that return (captured by the discount rate or “required return”), and
  3. The **Time Period** over which you will receive your return.
- BV analyzes and addresses these 3 factors.

INTRODUCTION TO BUSINESS VALUATION

- Essential to Business Valuation is that is a **Forward-Looking** exercise (expectation of future Cash Flow).
- It is based upon what you know at the Date of the Valuation.
  - Did the outlook for a Restaurant change between January 2020 and June of 2020? You bet it did! COVID-19.
  - An investor/buyer will look at the *Estimated Cash Flow Returns* AND the *Risk* of getting the cash flow. Both can change quickly.
- The Time Value of Money is always considered (present value).
  - A dollar today is worth more than a dollar next year.

INTRODUCTION TO BUSINESS VALUATION

- **Gordon Growth Model**

$$PV = \frac{E_1}{K - G}$$

- Where:
  - PV = Present Value (time value of $)
  - E_1 = Expected Cash Flow in period 1
  - K = Risk Adjusted Discount Rate, *"Cost of Capital"* or the Required Return
  - G = Expected L/T Growth in Cash Flow
- To keep it simple – remember the 2 parts: the Numerator (cash flow) and the Denominator (required return and risk).

INTRODUCTION TO BUSINESS VALUATION

- So, as Cash Flow increases, Value increases.
- As Growth increases, Value increases.
- But, as the Required Return increases, Value decreases.
- Observation: Risk increases the Required Return and most businesses have more risk than they realize.
- An overlooked way to increase Value is to decrease the Required Return (in particular the Risk associated with your business).

INTRODUCTION TO BUSINESS VALUATION

- When a Company wants to increase its value they typically focus only on the **Numerator** of the Value Equation.
    - They focus on increasing sales.
    - They focus on decreasing costs.
    - They focus on reducing debt.
    - They eliminate underperforming sectors of their business.
    - BUT, they often focus on Earnings/Net Income instead of the important measure…..**Cash Flow**.

INTRODUCTION TO BUSINESS VALUATION

- All of these are good practices if done in the correct manner.
  - Increased sales without adequate infrastructure can be a disaster in the long term.
  - Decreasing the wrong costs can hurt your ability to compete.
- As I indicated before – Don’t forget to look at the DEMONINATOR – RISK!

VALUE DRIVERS

VALUE DRIVERS

- A Value Driver is an activity or capability that adds worth to a product, service, or brand (things that drive the value of your Company).
- Focusing on Value Drivers can provide benefits to both the Numerator AND the Denominator of our Value Equation (increase cash flow AND reduce Risk and the Required Return).
- If you are positioning your Company for a sale or if you just want to increase its Value - evaluate the Value Drivers and their risks from the Buyer's perspective.
- Let's look at a few Value Drivers that may not typically be in a Company's first pass at increasing its Value.

VALUE DRIVERS

- Strong Management Team – Reduces the risk that value won't transfer to a new owner.
- Documentation of Processes and Developed Business Systems – Working, efficient processes and systems can reduce risk to a buyer.
- Diversified Customer Base / Recurring Revenue – The more of each the better. Reduces risk to a new owner. Lowers the risk for the loss of future revenue which might based on a relationship with current ownership.
- Minimize Supplier Risks – The last few years has shown many companies the negative impact of supply chain vulnerabilities. Diversifying vendor relationships can help reduce risk when supplies run short and during periods of increasing costs.
- Competitive Advantage – Know how you compete and what sets you apart. Focus on it. It can result in higher cash flow and less risk.

VALUE DRIVERS

- <u>Financial Performance</u> – Benchmark your company against peers. Steady growth / improving performance reduces risk.
  - Cash Conversion cycle – this is the Days Sales Outstanding + Days Inventory Outstanding – Days Payable Outstanding. This ratio calculates how long it takes a company to pay for and generate cash from the sale of inventory. This helps measure cash flow….the lifeblood of a business. Improvement in any of the components helps the ratio and reduces risk from a buyers perspective.
  - Actions like decreasing the collection time of receivables and extending payable terms also increase cash flow.
- <u>Model Future Cash Flows</u> – Develop spreadsheets to assist in modeling out future cash flows and performance. Using historical information and financial ratios can provide a useful tool to understand what is important to your business and assist with more accurate projections. Multiple scenarios can be developed using different economic assumptions to show the impact on your Company.

VALUE DRIVERS

- Scalability – Showing increased profit margins and cash flow as revenue increases. This reduces risk and is highly valued by buyers.
- Financial Foresight and Controls – Reliable financial reporting and accounting controls gives comfort to buyers and reduces risk. Remove discretionary or non-business expenses to show the true picture of cash flow.
- Consider developing a cash management strategy – using the cash flow projections mentioned earlier you can estimate when you will have excess cash and you can invest it in a sweep account for additional cash flow
- Quality of Earnings Analysis - consider doing one proactively if you are looking to sell

2024 ECONOMIC AND OTHER FACTORS

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- The broader economy, which is beyond the control of a business, can have a massive impact on a company's value.
- Each new year brings a new set of timely risks that a company must address to succeed.
- A good understanding of the current macroeconomic environment is important to be able to prepare for and mitigate risk factors that affect value.

2024 ECONOMIC AND OTHER FACTORS

- Fed interest rate policy remains at the forefront of investors' concerns.
  - Current projections published by the Fed on March 20 suggest that we will see 75 basis points of rate cuts by the end of the year.
  - Treasury rates impact the risk-free rate used in valuations and impact the cost of debt that a company will be required to pay.
  - Generally, as interest rates go up, values go down.
  - Unexpected changes in Fed policy or even changes in investors' expectations for the Fed will impact the value of a company.

2024 ECONOMIC AND OTHER FACTORS

- Supply Chain Disruptions
  - Many cargo ships have begun to avoid the Suez Canal by sailing around Africa due to unrest in the Middle East.
  - Escalation or new wars could cause companies to have increased difficulty in sourcing materials internationally.
  - Diversifying supply chains may be advisable for certain companies due to political unrest. A supply chain that is dependent on an unstable country is a risk factor that would be considered in a valuation.

2024 ECONOMIC AND OTHER FACTORS

- Fluctuations in the price of the dollar
  - As a net importer, the US has benefitted from a strong dollar in 2022 and 2023.
  - US Dollar depreciation against other currencies can cause materials sourced from other countries to be more expensive.
  - With the major central banks around the world in different stages of tightening and easing cycles, exchange rates can be expected to be volatile in 2024.

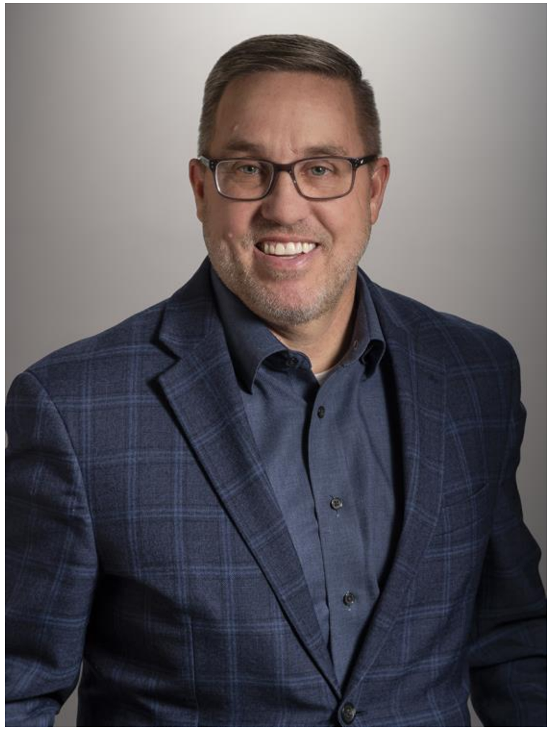
2024 ECONOMIC AND OTHER FACTORS

- Obsolescence caused by advancements
  - Technology is changing faster than ever.
  - Companies need to be aware of the latest technological or industry advancements and be ready to accommodate a shift in the demand curve or production trends.
  - In 2024, there is a particular uncertainty surrounding A.I. and the markets that it will disrupt as the technology becomes more advanced and more widely available.

2024 ECONOMIC AND OTHER FACTORS

- Community and Regional Banks
  - No one knows the extent of the unrealized losses held by the banks in their bond "held-to-maturity" portfolios.
  - Many commercial real estate loans are going to be reset over the next three years at much higher rates than what was originally underwritten.
  - New York Community Bank is very vulnerable and appears as though it may be the next high profile bank failure.
  - Make sure you understand FDIC insurance levels and identify whether your bank is a systematically important bank (aka too big to fail). If not, take necessary measures to make sure deposits are safe.

CONTACT INFORMATION



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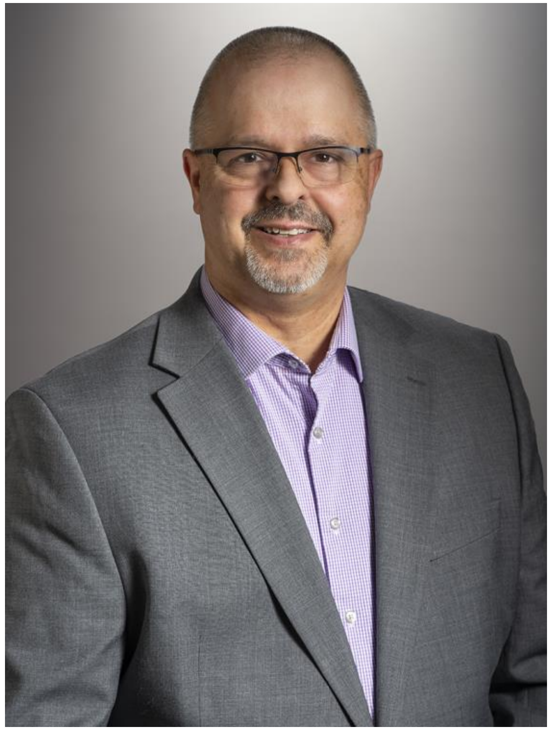

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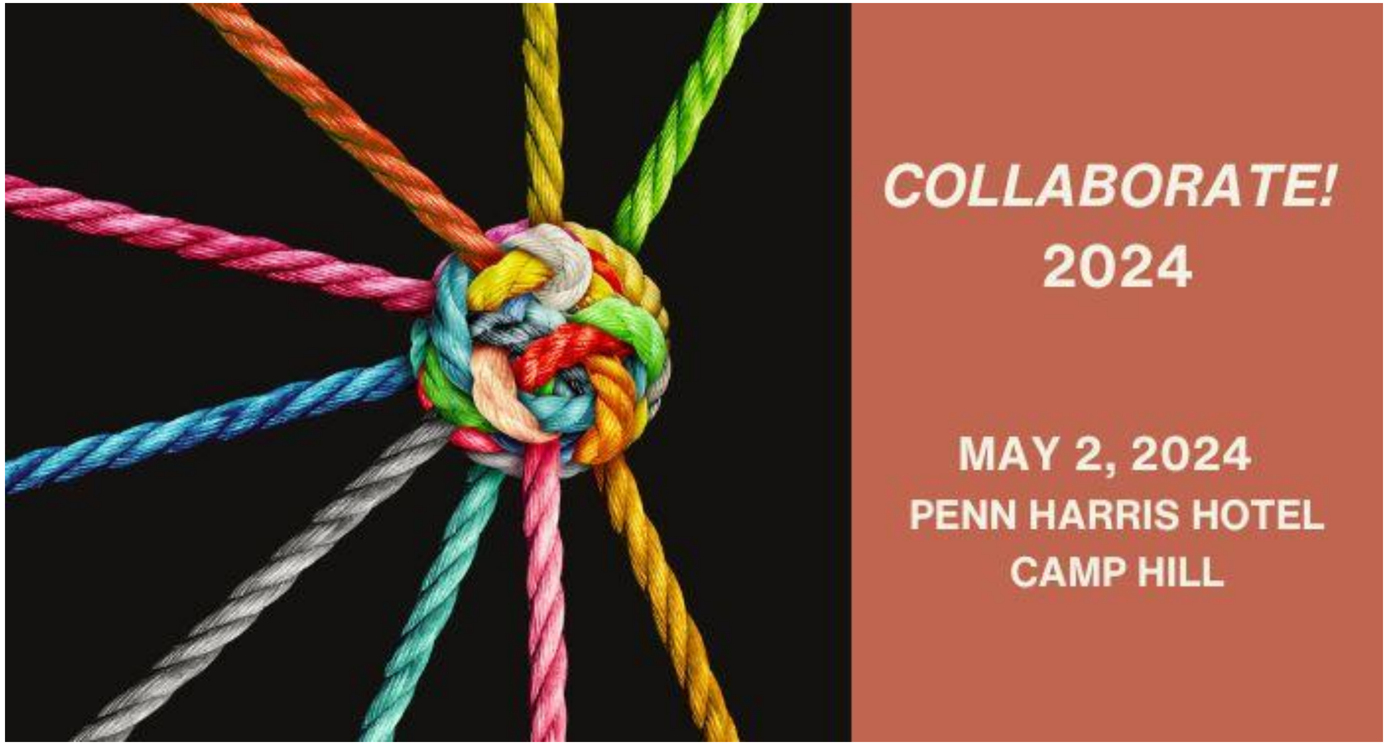

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