PRACTICE MANAGEMENT

Tips for Practitioners

FORECASTING METHODS HELP BUILD RELATIONSHIPS

By Steven Hutchison, CPA, CVA

Whether you are new to the field of business valuation or a long-time practitioner, demonstrating how you can help business owners improve the company's ultimate value of their business is important. In this article, the author discusses how showing an owner the fundamental insights of how forecasting works, can be a powerful tool.

WHEN A BUSINESS OWNER NEEDS A BUSINESS VALUATOR

Companies choose valuation analysts or business appraisers for many reasons. Often, however, they are not proactive in consulting a professional before a serious need arises. For example, most business owners will agree that valuation analysts and business appraisers[1] are reliable resources when they are contemplating ownership changes. They are less clear on when to bring in a professional. Worse, they often do not know what to expect from a business valuator.

While some ownership changes are strategic, many more can be random. For example, the owner of Acme Hardware is enjoying a nice dinner at the country club one Saturday and is approached by a potential buyer of her regional hardware stores with an enticing offer. At that point, the business owner starts looking for a professional who can act as a strategic consultant and valuable advisory resource. But, would it have been more effective to already have a relationship with a qualified professional? And, that being true, is it not a better option for you, the professional, to already have established the ground work for this relationship?

BUSINESS OWNER EXPECTATION VS. BUSINESS VALUATOR REALITY

Many analysts find it takes about twenty-four to thirty-six months working with a company to develop and implement an effective strategic business plan. In our practice, we have encountered many business owners who have pre-set expectations of exiting within six to twelve months of our first meeting. This presents a conflict in the time gap between what is expected and what is possible.

When making your pitch to small to mid-sized business owners, it is important to underscore the value you bring to the table. One of the best ways to do that is to demonstrate how your ability to create long-term financial forecasts and routinely analyze actual results against the forecast is an important feature to enhance business operations and add to the business value.

Forecasting may seem like a common practice and likely occurs in some form across many small and mid-sized businesses. However, the step often missed is the analysis comparing actual results against the forecast. This step provides the most significant, insightful benefit because it requires management to understand "why" performance varied and may encourage operational changes using lessons learned. This practice is useful to all companies, not just those seeking an exit plan. The added side benefit is that it provides insight towards understanding and growing the business' value when utilizing valuation professionals for this practice.

1 Credentials within the business valuation world include Certified Valuation Analysts (CVA); Accredited in Business Valuation (ABV); Accredited Senior Appraiser (ASA); and Certified Business Appraiser (CBA).

FORECASTING AND BUSINESS VALUATION

As we know, many small to mid-sized businesses are valued based on the earnings of the organization (Income Approach). Other approaches are relevant at times, such as a real estate holding company appraising its assets (Asset Approach) or larger operating companies comparing the business to similar sales transactions in the market (Market Approach); but, the Income Approach is commonly used for small and mid-sized businesses.

When describing the Income Approach, we often focus on the two primary methods: 1) the capitalization of earnings method (cap earnings) and 2) the discounted cash flow method (DCF). From a theoretical perspective, they share common elements. Both use a foundation where the company is valued based on the future earnings it is expected to generate; and both normalize the cash flows to remove any non-operating or exceptional and extraordinary items providing a better measure of the true economic income, assets, and liabilities.

The main difference is how the future earnings of the company are derived. The cap earnings method uses historical results to obtain the future benefit stream based on the logic that normalized historical performance represents future stable and sustainable growth. This benefit stream is then capitalized by a capitalization rate. Since the cap earnings method assumes historic results are indicative of future[2] results, this method is best used for mature organizations with consistent historical results where no major changes are anticipated in the immediate future.

Alternatively, the DCF method is based on a benefit stream that uses forecasted earnings to calculate value. The forecasted earnings incorporate specific year-over-year changes relating to growth, operations, debt, and capital expenditures, to name a few. The logic here is that performance in the foreseeable future will vary significantly compared to historical performance. In applying the DCF approach, each future change in cash flow is estimated for that specific year. This requires forward-looking forecasts providing flexibility to incorporate annual changes. Usually, the DCF method is most effective when historical performance is variable and variable changes are expected to occur in the future.

For many business owners, future performance of the company could be significantly different from what it is today and informed realistic forecasting clarifies where performance is heading. Let's look at one example we recently encountered:

EXAMPLE:

The owners of a plumbing company requested a valuation for a one hundred percent sale to its employees. The company averaged $6.5 million in sales, had normalized net-of-debt after-tax cash flow of roughly 10.2 percent, and the long term sustainable growth rate was three percent (this was supportable). Using the cap earnings method with a capitalization rate of 19.1 percent (using the Ibbotson Build-up Method) the equity value was roughly $3.33 million before any marketability discount.

Initially this value seemed reasonable. However, we had regularly worked with management preparing forecasts, analyzing results, and re-forecasting based on lessons learned. Management was aware of major changes that would occur in the next few years. They had two new long-term contracts phasing in over thirty months. The contracts would increase sales to $8.2 million. Additionally, operations would gain significant efficiencies at the new revenue levels. Working with management, we could model the expense effect, analyze, scrutinize, and finally, support a reasonable forecast. The key was the ability to support the expectations. The forecast included an increase in net-of-debt after tax-cash flow both in dollars and as a percentage of sales: (the simplified results are shown in Figure 1)

Using the supportable forecast, the equity value jumped to approximately $5.7 million under the DCF method, before marketability discount. The difference of

2 Capitalizing averages the estimated rates of changes in future cash flows into one annually compounded growth rate, which is then subtracted from the discount rate. Cost of Capital, 3rd Edition, Shannon P. Pratt, Roger J. Grabowski.

FIGURE 1:

Benefit Stream	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Net of Debt After Tax Cash Flow	1,074,611	1,182,072	1,229,355	1,278,529
Discount Rate	22.9%	22.9%	22.9%	22.9%
Years into the Future	1	2	3	4
Net Present Value	874,521	782,856	662,573	560,771
Terminal Value				
Benefit Stream in Las Year (year 4)	1,278,529			
Divided by Cap Rte (a)	19.9%			
Terminal Years into the Future	6,424,769			
Net Present Terminal Value at 22.9% Disc. Rate	2,816,112			
Equity Value	5,696,833			

more than two million dollars between the cap earnings method and the DCF method is significant.

The valuation process would uncover the new sales contracts and most (if not all) valuation professionals would incorporate the effect into the calculation of value. The real benefit from the relationship was the ability to understand, estimate, and support the effect on operational expenses.

Additionally, the business owners were only "thinking" about retirement but were not sure if it was the right time. Since we had an ongoing advisory relationship and created reliable forecasts, we could reasonably estimate the business' value incorporating today's efforts without waiting two to three years to see the results in the historical financial statements.

AN ADVISORY RELATIONSHIP FORECASTING WITH PERIODIC BUSINESS ANALYSIS

Entrepreneurial business owners need to anticipate, plan, and react as they lead their organizations. Financial statements act as the stat sheet and forecasts help develop a future game plan. A business owner planning and forecasting twenty-four to thirty-six months into the future (or longer) and consistently analyzing reliable results versus the forecast that can identify trends, make modifications, clarify risks, and capitalize on opportunities.

In working with many of our clients, we have found that forecasting for small and mid-sized businesses is useful in their day-to-day operations. Once created, the forecast becomes an interactive model to make strategic decisions such as hiring key employees, financing capital improvements, and anticipating tax liabilities. Ultimately, this practice helps strengthen cash flow, which indirectly strengthens the business' value. One of the comments you may get is, "This looks great, but why should I use a valuation analyst to support this role in an ongoing capacity?"

The response to that is twofold:

- To be effective, an appropriate financial professional should be responsible for the forecasting process and review the forecast model. Many small and mid-sized organizations have strong bookkeepers in charge of financials, but the bookkeeper may not be the best suited for forecasting. Engaging a valuation professional to take on this role is like hiring a part-time CFO since they can also serve in an advisory capacity.
- A relationship like this is also a more reasonable investment for companies who do not have the capacity or the capital for a full-time CFO.

The leaders of the organization are accountable in the forecast process too; they are the experts in their industry. The leaders must spend time with the valuation professional discussing future operations. The valuation professional will translate the operation discussions into figures for the forecast. The figures and discussion topics should be revisited until the team agrees on the most reasonable forecast for the period.

Finally, on either a monthly or quarterly basis, compare actual results against the forecast and spend time discussing the variances. We believe this is the most important step in the process. The goal is to understand why performance was better or worse and to utilize the lessons learned to strengthen operations. Future periods may be re-forecasted based on the findings to chart the new trajectory.

CONCLUSION

Forecasting and regularly analyzing the results helps business owners develop strategic plans to improve operations and increase cash flow. As cash flow increases, the business value also increases. As noted in our example, our client negotiated and achieved an extra two million dollars on the sale of the business because they had a clear financial model highlighting the future cash flows of the business.

Most entrepreneurial business owners understand that today's efforts are reflected in tomorrow's performance. Valuation professionals serving in forecasting and advisory roles will pay dividends in all aspects of the company, and will strategically clarify and signpost the value of the company. VE

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