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FSAT NEWS

FINANCIAL SERVICES ADVISORY TEAM

SPRING/SUMMER 2022

Welcome to our 27th issue of FSAT News, a newsletter published by DJB's Financial Services Advisory Team (FSAT) to better inform and help you manage your business's potential.

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Understanding "Enterprise Value" and "Equity Value"

When business owners discuss valuations, they sometimes use the term "price." However, there is an important distinction in business valuations between "value" and "price." In business valuations, practitioners usually prepare a notional determination of "fair market value." In addition, a notional determination of value is typically first approached on a "debt-free, cash-free" capital structure, with additional adjustments as discussed later in this article.

Fair market value is typically considered to represent the highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, each acting at arms-length in an open and unrestricted market, when neither is under compulsion to buy or to sell and when both have reasonable knowledge of relevant facts.[1]

When discussing business value with owners, one key area that is often misunderstood is the difference between the "enterprise value" and "equity value." In order to understand the distinction between the two, it is important to consider the definition of fair market value above, and how it is calculated.

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[1] *CBV Institute Practice Bulletin No. 2 International Valuation Glossary – Business Valuation*

(article continued from page 1)

Most operating businesses are valued on a going concern basis, which means the business is assumed to continue to operate for the foreseeable future. This is because in most operating businesses, the value of the future economic benefit generated is greater than the value of the underlying assets employed in the business operations. When this is the case, the value of the overall business enterprise is greater than the value of its underlying assets and liabilities, and therefore a buyer would be willing to pay more to purchase the business altogether instead of the individual assets and liabilities separately.

One of the primary going-concern approaches to valuing a business is to employ a cash flow or earnings-based valuation methodology, which values the business based on its ability to generate future cash flows. Common cash flow-based valuation methodologies include applying a multiple to either the business' sustainable level of cash flow or EBITDA (earnings before interest, taxes, depreciation, and amortization) when earnings are relatively stable, or when changes are expected through a discounted cash flow analysis, where annual future cash flows are discounted based on the risks related to the business, as well as the timing of when the results will be achieved.

What is Enterprise Value?

The above mentioned cash flow/earnings based valuation methodologies each result in the calculation of Enterprise Value, which is the total economic value attributable to the business enterprise, regardless of how it was financed (i.e., debt and cash) or its share structure. Enterprise Value is the "debt-free, cash-free" concept introduced earlier and can also be thought of as the value available to all debt providers, common shareholders, preferred shareholders, etc. Because Enterprise Value represents the business before financing and other discretionary amounts, it does not include the value of cash, non-operating assets or liabilities, or shareholder loans since they are not part of normal business operations.

What is Equity Value?

Equity Value is the value attributable to the shareholders' equity of the business, including all preferred and common shareholders. In other words, is the value available after any payment to creditors and other non-equity stakeholders. The Equity Value of a business is determined by subtracting outstanding debt and other non-operating liabilities from the Enterprise Value of the business and adding any cash and redundant other non-operating assets.

The distinction between Enterprise Value and Equity Value is not always widely understood. Often, when a business is sold an initial offer is made on a cash-free and debt-free basis or Enterprise Value. In reality, at closing, any debt is deducted from the original price and the value of cash and other redundant assets may be added to come to a final price that is paid for the shares or Equity Value of the business. Another important consideration is the normal working capital requirements of the business, as the extent that there is too much or too little working capital in the business may lead to another significant adjustment. As a result, the working capital needs of the business should be carefully analyzed because this can be a dollar-for-dollar adjustment to the Equity Value, which we will discuss in detail in a subsequent article.

Implications for Business Owners

When discussing business value, owners may not appreciate some of the key differences between Enterprise Value and Equity Value. A common misunderstanding is related to the impact on Equity Value from shareholder/related party loans. Owners often move cash in and out of their corporations for risk management and other purposes. When a business begins, the owner or key investors will lend funds to the newly formed corporation in the form of a shareholder loan or loan from a related company. As a business matures, dividends may be declared and then loaned back to the business for operational purposes. When valuing the shares or equity of a corporation that has loans from shareholders or other related parties, the value of these loans must be deducted from the Enterprise Value of the business along with any other debt and non-operating assets and liabilities. However, it is important to note that the shareholder loans would typically be paid out on a tax-free basis, because these loans were made by the shareholders with after-tax dollars. As a result, owners or sellers should have an understanding of the after-tax proceeds in a potential transaction.

Business owners also often ask about non-operating or redundant assets held in a business, which also impact the Equity Value. Some common examples of these assets include excess cash, marketable securities, real estate, personally used vehicles, and loans receivable (including from shareholders or other related parties). Since these assets do not relate to the ongoing business operations, their values are added to the Enterprise Value in determining the Equity Value.

Identifying redundant/non-operating assets is an important step when preparing a business for sale. Generally, potential buyers are not interested in purchasing these redundant assets or will not pay for their full value since they are most interested in the core operations. When this is the case, it is typically better for the owner to sell or transfer these assets out of the business prior to closing a sale. However, it is not always easy to carve out redundant assets or liability when a business is sold and it is therefore important to understand these items if considering a sale transaction and to work with the appropriate advisor.

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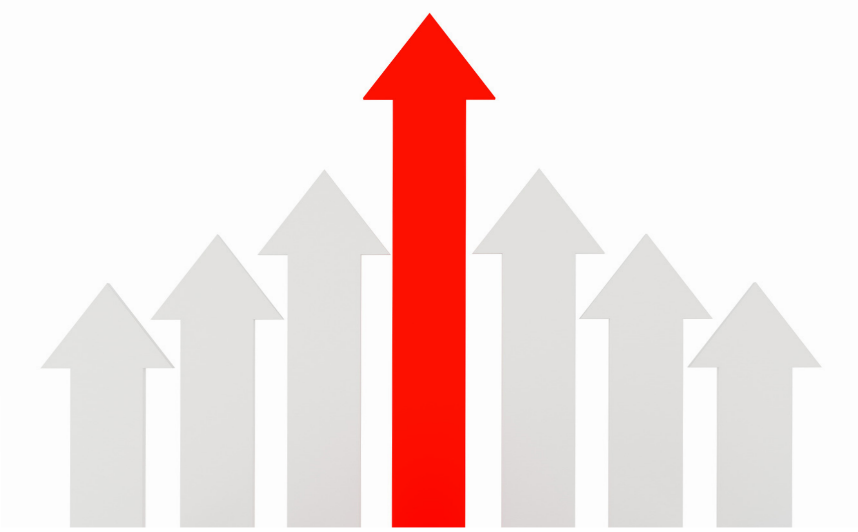
"Special Purchasers" and Their Impact on Fair Market Value



There are many instances when a formal business valuation is required regarding the fair market value of a business without exposing it for sale to the open market. For example, business valuations are often required when a business is not changing hands but the fair market value is still needed, such as for income tax and estate planning, family law matters, and for commercial litigation. When a business is valued without being placed for sale on the open market, the fair market value of the business is considered to be determined on a 'notional' basis. Since the business is not placed on the open market, Valuators must rely on theoretical principles, past experience, and their professional judgment in order to determine the fair market value a notional basis.

When assessing the fair market value of a business in a notional context, there are two components to value that are considered; the first is the "intrinsic" value of the business, which is the value that buyers will place on the stand-alone business assuming it will continue to operate as-is, and the second is any additional value above the intrinsic value that hypothetical buyers in the market would expect to receive as a result of integrating the acquired business into their existing operations and any other benefits they expect to receive as a result of the acquisition.

Special Purchasers

Buyers that are expected to realize additional value from an acquisition above the intrinsic value of an acquired business are referred to as "special purchasers". A special purchaser is defined in Canadian business valuation theory as a purchaser "who can, or believes they can, enjoy post-acquisition synergies or strategic advantages by combining the acquired business interest with its own". These special purchasers are willing to pay a premium for the business above its intrinsic value because they expect to benefit from these post-acquisition synergies, economies of scale, or strategic advantages that are a result of combining the acquired business with their own.

Synergies

Special purchasers are often interested in acquiring a business in order to realize synergies. Synergies occur when the value of two combined entities is greater than the intrinsic value of each on their own, and typically arise as a result of new cost savings or increased revenues post-combination. Some examples of common synergies are increased purchasing power, reduced costs, lower debt interest rates, and increased diversification. It is generally difficult to determine the value of synergies when assessing the fair market value of a business. This is because each potential acquirer of a business typically has different types and amounts of synergies they expect to realize from an acquisition.

Economies of Scale

Economies of scale are cost advantages that a business receives as its operations grow and become more efficient. This can occur because when the volume of output of a business increases, the costs can be spread out over a larger amount of goods/services. When economies of scale exist, the value of the combined businesses to the purchaser is greater than the value of each business separately. In such cases, these buyers would be considered special purchasers since they would potentially be willing to pay more for the business than a buyer who is not able to take advantage of these economies of scale.

Strategic Advantages

Special purchases may also be motivated to purchase a business in order to receive greater strategic advantages. These buyers typically already own operating businesses in the same/similar industry, and are motivated to purchase other businesses in order to advance their strategic goals, such as eliminating a competitor, acquiring new technologies, or growing into a new geographic area. Often these special purchasers are competitors, suppliers, or clients of the subject business.

When Are Special Purchasers Considered?

In Canadian business valuation theory, the "highest price" component of the fair market value definition mentioned earlier in this article is assumed to include the consideration of potential special purchasers, as these buyers are expected to offer a higher price for a business than non-special purchasers. However, Canadian legal precedents generally dictate that when the notional fair market value of a business is required, consideration should only be given to special purchasers when such buyers are readily identifiable in the market and the price premiums they would be willing to pay can be reasonably estimated.

Even if it is believed that hypothetical buyers in a notional context may be able to realize synergies, economies of scale, or strategic advantages, it is often still difficult to determine to what level (if at all) these buyers would be willing to pay the seller for the additional value. For instance, in cases where only one special purchaser is thought to exist in the market, this special purchaser is not expected to pay a premium above the intrinsic value of a business for such benefits if they are the only buyer that could realize them. However, when multiple special purchasers exist, increased competition between these buyers to purchase the business and access these additional benefits is expected to result in the buyers offering more than the intrinsic value to acquire the business.

In such cases, valuators will examine the probability and number of special purchasers for a business that exist in the market, their ability and willingness to transact, and the estimated size of any premiums these special purchasers might pay. However, often the information available to valuators is not sufficient to determine with certainty the existence of special purchasers for a business and the size of any special purchaser premiums. It is also possible that the "special purchaser" premium warranted is already reflected in the calculated value if the calculations are based on multiples derived from actual market transactions which may already reflect industry-wide premiums. If this is the case, then no additional special purchaser premium should be considered.

A special purchaser premium is usually only considered in the notional fair market value of a business when these special purchasers in the market can be identified, and the additional value to each prospective buyer can be meaningfully quantified. When this is the case, it may be reasonable for valuators to attempt to determine the value of the business including the synergies, economies of scale, and strategic advantages that these market participants could reasonably be assumed to benefit from. However, this additional value is usually discounted to reflect the uncertainty of how much a special purchaser would pay for these additional benefits, and the risks associated with achieving them.

Acquiring a Business as a Special Purchaser

In addition to scenarios where the notional fair market value of a business is required, valuators may also be asked by potential special purchasers in a business acquisition to assist in quantifying the additional value that should be paid for the target business above its intrinsic value. In this case, valuators may attempt to determine the value of the synergies, economies of scale, and/or strategic advantages that will arise from the acquisition being considered. However, even if the additional value above the intrinsic value of the business can be reasonably determined it is often still difficult to determine to what extent the purchaser should pay for this additional value. Generally, when a business is purchased with the intent of realizing synergies, economies of scale, and/or strategic advantages, the additional value paid for the business above its intrinsic value is determined as a result of negotiations between the buyer and seller.

If you are considering a sale transaction where a "Special Purchaser" may be involved, we can help guide you in the right direction.

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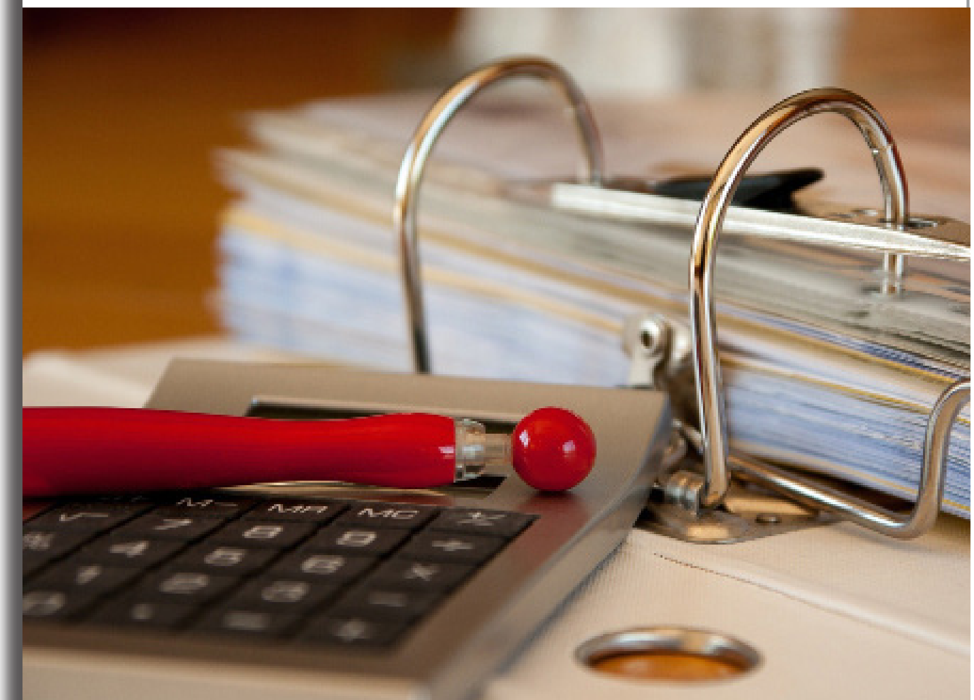
FSAT SERVICES

- Assistance with Business, Acquisitions & Divestitures, Including Due Diligence & Quality of Earnings Reports
- Business Interruption Insurance
- Business Valuation
- Collaboratively Trained Professionals
- Child & Spousal Support Income Calculations
- Economic Loss Calculations regarding Motor Vehicle Accidents, Slip and Fall, Medical Malpractice and Dependency Claims
- Experienced Expert Testimony
- Forensic Accounting
- Income Replacement Benefit (IRB) & Other Accident Benefit (AB) Calculations
- Long-Term Disability Calculations
- Matrimonial Disputes
- Shareholder Agreements & Dispute Resolution
- Value of Future Care Cost Analysis
- Wrongful Dismissal Claims

Discount Rate Remains at 0% for trials in 2022



For the 3rd year in a row, the discount rate to be used to calculate future economic losses will remain at 0% for the first 15 years, and 2.5% thereafter.

Each year the Ministry of the Attorney General of Ontario publishes the discount rates to be used for the calculation of awards for future pecuniary damages in Ontario under rule 53.09 of the Rules of Civil Procedure. The rates are based on calculations set out in the Rules of Civil Procedure.

For trial scheduled to commence on or after January 1, 2022, the rates are as follows.

- For amounts expected to increase with inflation (e.g. salary), the discount rates to be used remain at 0% for the first 15 years and 2.5% thereafter.
- For amounts that are static (that don't increase with inflation), such as Income Replacement Benefits (IRBs) or many Long-Term Disability benefits, a higher discount rate would be warranted. Based on the Attorney General published inflation rates, the discount rates for such amounts will be 1.8% for trials beginning in 2022, up from 1.0% for 2021. As this discount rate has increased, the present value amount will be slightly lower under the new rates.

Our Financial Services team has significant experience preparing these present value calculations. If you have any questions or require assistance with a calculation, please contact a member of our team.

DJB Contacts Interested in Buying & Selling Businesses - May 1, 2022

We have clients and contacts that are interested in buying or selling businesses. If you see a possible fit, please contact us so that we can arrange an introduction for you.

BUYERS

- Private Equity Group that buys majority positions in Canadian companies with EBITDA → $2m for long-term hold and growth.
- Looking for a cleaning/vacuuming (not janitorial) company in Southern Ontario.
- Private Equity Group providing capital and strategic partnerships to $.5 to$3.0m EBITDA businesses in Cda, primarily Ont and BC.
- Interested in an owner operator retirement situation with approx $250k to lever with VTB for acquisition.
- $500k to $4m, in any industry, will consider partnership and investment opportunities, including managing or running a business with a minority stake.
- Two entrepreneurs backed by 16 investor fund looking for $1.5m+ EBITDA and =→ 20% ROC.
- Wholesaler of welding supplies interested in similar businesses in Canada or USA with an EV up to $5m.
- Foreign (US) shareholders' investment company makes acquisitions across North America in the manufacturing and agricultural sectors (large farming corporations) with an EV up to $5m.
- Food Producer (Pasta/Pizza sauces, Salsa, etc.) and Distributor with $4.5m sales looking to buy complementary profitable food production company with about $1m in sales.
- Looking to grow by acquiring HVAC or related companies in the $1-10m sales range in the Hamilton/Halton/Niagara regions.
- Operates an importing business specializing in household (ie – kitchen) gadgets sold to grocery and box store chains. Interested in complementary businesses as well as Hamilton based real estate investment opportunities.
- Diversified asset management firm focusing particularly on the technology, media, service, renewable energy, real estate and hospitality sectors.
- Entrepreneurial investment firm seeking to acquire and grow a small to medium-sized business. Looking for a company with annual revenues from $5 to $30 m and EBITDA from $1 to $5 m, anywhere in Canada.
- Retired individual looking for business to run part time possibly involving his son.
- Potential client with $25m annual revenue in mechanical systems for industrial, commercial and institutional construction looking to acquire complementary businesses in SW Ontario.
- Investment partnership acquiring Canadian companies with $1m to $6m EBITDA.
- Acquires controlling interests in Canadian companies with $1m to $5m EBITDA.
- Manufacturing business within 100 km of Hamilton, sales $5m to $10m, EV $2m to $3m, could buy in over time or take a significant ownership % and a senior management role.
- Up to $7m to invest in auto dealership, wholesale distribution of electrical or HVAC and/or businesses that serve the construction or manufacturing industries.
- Broker looking for larger real estate offices for acquisition. Would consider any office over 15 people in the Kitchener, Guelph, Milton, Mississauga or Brampton markets and any office with over 50 agents in the Burlington, Hamilton or Oakville market places.
- Two partner firm in the GTA looking to acquire $3m to $10m EV businesses in the GTA/Hamilton area.
- Interested in troubled situations, successions or high growth companies in distribution or manufacturing.
- $1.5m to lever into a business acquisition.
- Private Holdco looking for investments in the GTA in the industrial manufacturing or services industry. Revenue → $8m and pays 3 to 4 times EBITDA.
- Lives in N-O-T-L with approx $250k cash to lever into business acquisition.
- Investment group, enterprise value up to $12m, within 90 minutes of Kitchener.
- Investment group, Oakville or West GTA, EV $1m to $10m.
- Investment group with approx $10m equity to place.
- Marketing individual looking to become co-owner/manager in small company.
- Private equity firm, seeking $10m to $15m enterprise value, 100% sale, owner-operator looking to transition out, Niagara region.
- Seeking an enterprise with a strategic fit to their business, serving Industrial Distributors, with sales in the range of $1m to $20m.
- Already made one acquisition in the food service industry and are interested in related industry and/or other good opportunities.
- Historic earnings with potential, located in the Toronto through St. Catharines area, existing management and price of $1m - $3m.
- Anything profitable. Niagara Falls to Oshawa. Up to $1m.
- Investment group looking for companies with $3m-$30m in sales, focused on B2B services, Healthcare services and software.

SELLERS

- Medical-legal personal injury graphics business. Sales approx $1.2m with 10 to 15% pre tax income.
- Custom brokerage. Sales approx $900k p.a. Asking $1.5m for 100% of shares.
- Security systems and equipment. Sales approx $1.6m and EBITDA approx $250k.
- Engaged in the development, training, and sale and support of business applications software. Revenue of approximately $4m per annum.
- Manufacturing business in the Kitchener/Waterloo/Guelph area with approx $3m in sales and EBITDA of $250 - $500k.
- Retail pet food and supplies store.
- Corporate group includes a poultry wholesale, distribution and refrigerated logistics company and a boutique retail food store company. Total sales $7m.
- Exterior building, vehicle, driveway, sidewalk cleaning service with 2 self contained trucks. Annual revenue approx $165k.
- Engaged in removal & disposal of liquid waste & the performance of environmental audits. Sale of 50% interest by one of two shareholders.
- Restaurant including the land and building. Asking $3m.
- Machine shop specializing in large machining and fabricating and also providing comprehensive support services. Sales approx. $2.9m and EBITDA approx. $325k.
- A distribution company with $5m+ in sales.

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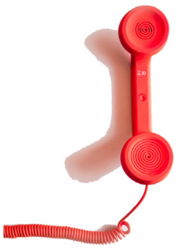

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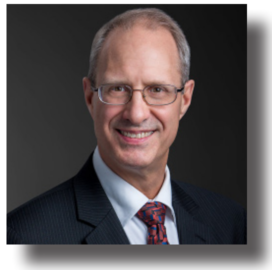

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