Valuation, Price, & Lender Approvals

There are several ways to analyze the financial health of an investment advisory business and get to a purchase price that is amenable to the buyer, seller, and any other stakeholders in the transaction. For instance, a valuation company is going to analyze the business in a different manner than a financial institution funding the transaction. Each stakeholder conducts their own unique, interdependent due diligence, and it is important to understand what each stakeholder is looking for when they complete their valuation.

When looking to assess the financial health of your business, or if a buyer and seller are looking to start negotiations, the best place to begin is often to get a business valuation. Because advisory businesses are service-oriented and do not have many tangible assets on the balance sheet, investors or buyers are often looking at the earnings, and ultimately the cash flow, of the business to render a value. This notion can be confusing for potential dealmakers because conversations around market value often start with a revenue multiple. While that may be one point of interest in initial negotiations, this frequently leaves out discussions around profit margin, efficiency ratios, earnings growth, and other data points that are important when valuing a business.

When analyzing and valuing a business based on cash flow, there are several ways that stakeholders will make decisions around value and the ability to provide capital. For instance, valuation companies alone have multiple methods to determine value—depending on the circumstances, they may use market value based on comps, multiples of earnings, or a discounted cash flow analysis to name a few. The ultimate valuation figure is commonly a number based on an average transaction structure.

A valuation gives you a good idea of enterprise value; however, it is rare that the purchase price of the business is simply equivalent to the valuation, as the terms of the deal will affect the purchase price. Some valuation firms will provide potential deal structures and guidance on how those structures should warrant a premium or discount to the price. This assessment is based partially on risk. With an all-cash offer, the buyer is taking on all the risk and the seller's involvement post-closing may be limited, so the buyer might get a discount on the price. On the other hand, a transaction that is highly contingent on performance with a smaller down payment will shift much risk to the seller and will usually result in a premium. Bank-financed sales often require seller covenant even when a down payment is high, which also tends to balance the risk.

The structure of the transaction will affect the analysis done by lenders or other providers of capital. Lenders look at the repayment ability of the business in addition to the value of the firm. This can be called a debt service coverage ratio, which, simply stated, measures whether there is enough cash flow to cover the annual principal and interest payments of the note with a buffer (annual cash flow or annual debt service). This can be calculated on a historical basis, but lenders will also consider projections to see what the firm's revenues will look like the future. Also, there will be a focus on revenue and earnings growth and on whether acquisitions will bring economies of scale to the business.

The deal structure, like the valuation or purchase price, will influence the lender's analysis, specifically as it relates to the denominator in the debt service coverage ratio mentioned above. The denominator in that equation is the annual debt service, which is a combination of lender debt and any seller note that the buyer is responsible for. If the term of the seller debt is a typical three to five years, the annual debt service will be higher for that portion of the purchase price than for a typical ten-year lender note. It is the lender's job to assist in creating a structure that contemplates the risk between buyer and seller, in addition to making sure the debt service coverage ratio meets bank guidelines.

As you can see in Table 12.1, Example 2 has less total annual debt service because of the discount given to the purchase price and the larger portion of the debt (75%) put over a ten-year term instead of a five-year term. These examples do not contemplate whether Example 2 is too risky for a buyer, but offers some insight into how lenders are looking at the transactions. As mentioned earlier, the lender's job is to balance the buyer's ability to pay and the structure that will lead to loan approval.

Although cash flow lenders and other providers of capital look to a borrower's earnings as the primary source of repayment for a loan, they also examine the borrower's balance sheet. If companies keep cash on hand and invest retained earnings back in the business instead of distributing the net income to the

Figure 12.1 The Effect of Deal Structure on Financing

	EXAMPLE 1	EXAMPLE 2
Purchase Price	$1,000,000	$900,000*
Bank Note (10-yr. term, 7%)	$500,000	$675,000
Annual Debt Service	**$69,665**	**$94,048**
Seller Note (5-yr. term, 7%)	$500,000	$225,000
Annual Debt Service	$118,807	$53,463
Total Annual Debt Service	$188,472	$147,511

Discount due to increased down payment

owners, they will provide additional strength to anyone making an investment or a loan to the business.

It is critical to understand how stakeholders assign worth to advisory businesses in order to increase the value of your firm, obtain capital for growth, and have the ability to sell your firm when the time is right. The good news is valuation firms that are industry-focused will be able to provide this type of consultative support and help you increase the value of your firm.

Mike McGinley, Live Oak Bank

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