Succession Planning II

Valuing Your Bookstore

BEA Workshop

May 31, 2003

Elements of Succession Planning Success

1. Allow ample preparation time
2. Develop a thorough sales document
3. Know your ideal buyer and transaction
4. Use professionals as needed
5. Make an orderly transition

1. A Tale of Two Stores
2. Four valuation approaches
3. Common valuation issues
4. Sample results – including three actual sales

1 - A Tale of Three Stores

- Cora's Corner

- Barney's Booksmith

Cora's Corner

Revenues	$300K
Net inventory cost	$50K
Other net assets	$10K
Owner's comp	$25K
EBIT	$9K
Pre-tax capital cost	12%
Proj EBIT growth	0%
Value	???

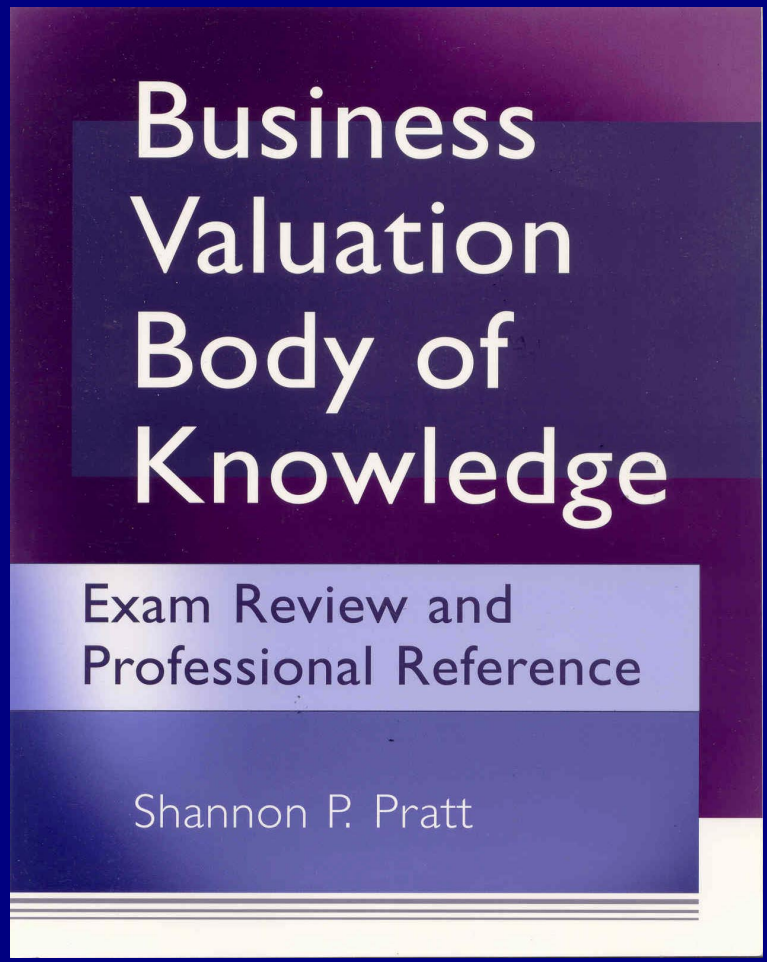
- Small store on Jersey Shore
- 7 years old
- Seasonal trade
- Cora was successful on Wall Street
- Bruce Springsteen gets his lyrics here

Barney's Booksmith

Revenues	$1.2 mm
Net inventory cost	$200K
Other net assets	$10K
Owner's comp	$125K
EBIT	$30K
Pre-tax capital cost	12%
Proj EBIT growth	1%
Value	???

- Mid-size college-town store in Austin
- Strong customer resistance to chains
- 22 year history
- Larry McMurtry buys his used books here

1. A Tale of Two Stores
2. Four valuation approaches
   A. Market Approach
   B. “Horse Trading”
   C. Cash Flow Method (earnings-based)
   D. Excess Earnings Method (asset- and earnings-based)
3. Common valuation issues
4. Sample results


Business
Valuation
Body of
Knowledge
Exam Review and
Professional Reference
Shannon P. Pratt

A - Market Approach

1. Based on universe of comparables
   a) Similar entities in similar locations
   b) Public companies in same business
2. Similar to a real estate appraisal
3. Shortage of comparables for independent bookstores

B - “Horse Trading”

1. Common starting place because it requires the least work
2. Based on each side’s experience and feel
3. Very difficult to establish a positive transaction where both sides believe that the deal is fair
4. High potential to result in a dead deal

1. Assumes business is like an investment in a stock or bond – it is worth the present value of estimated future cash flows
2. Simplified process:
   a) Estimate a normal EBIT
   b) Estimate the expected capital cost
   c) Estimate expected annual growth rate for the business over time
   d) Subtract c) from b) and divide into a)

$$\frac{\text{Normal EBIT}}{\text{Capital Cost} - \text{Projected Growth Rate}}$$

D – Excess Earnings Method

1. Assumes business is worth value of net tangible assets plus or minus an adjustment for earnings in excess of those needed to support the investment in the assets
2. Simplified process:
   a) Calculate net tangible assets
   b) Estimate a normal EBIT
   c) Estimate capital cost to justify the net tangible asset investment (often lower than average cost of capital)
   d) Estimate expected capital cost for the excess earnings (often higher than average cost of capital)
   e) Add a) plus [[b) less multiplication of a) times c)] divided by d)]

$$\text{Net Tangible Assets} + \frac{\left(\text{Normal EBIT} - \left(\text{Net Tangible Assets} \times \text{Net Asset Capital Cost}\right)\right)}{\text{Excess Earnings Capital Cost}}$$

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- Assets/inventory at cost or market?
- Reasonable capital costs?
- Reasonable owner's compensation?
- Growth rates based on history, competitive environment, or plans?
- Influence of risk and uncertainty on the final calculation?

1. A Tale of Two Stores
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4. Sample results

ILLUSTRATIVE

- Cora's Corner
  - Cash flow method: $75,000
  - Excess earnings method: $84,000

- Barney's Booksmith
  - Cash flow method: $682,000
  - Excess earnings method: $626,000

ILLUSTRATIVE

Revenues	$300K
Net inventory cost	$50K
Other net assets	$10K
Owner's comp	$25K
EBIT	$9K
Pre-tax capital cost	12%
Proj EBIT growth	0%
Value	$75,000

Cash Flow Method

- Owner's comp is at market, so no adjustment
- Normal EBIT = $9K
- Pre-tax capital cost less expected growth 12%-0% = 12%
- Value: $9K/12% = $75,000

ILLUSTRATIVE

Revenues	$300K
Net inventory cost	$50K
Other net assets	$10K
Owner's comp	$25K
EBIT	$9K
Pre-tax capital cost	12%
Proj EBIT growth	0%
Value	$84,000

Excess Earnings Method

- Owner's comp is at market, so no adjustment
- Net tangible assets = $60K
- Justification for NTA investment at 9% = $5.4K
- Excess earnings: $9K – $5.4K = $3.6K
- Value: $60K NTA + $3.6K/15% = $84,000

ILLUSTRATIVE

Revenues	$1.2 mm
Net inventory cost	$200K
Other net assets	$10K
Owner's comp	$125K
EBIT	$30K
Pre-tax capital cost	12%
Proj EBIT growth	1%
Value	$682,000

Cash Flow Method

- Owner's comp is high, so $45K moved to earnings
- Normal EBIT is $30K + $45K = $75K
- Pre-tax capital cost less expected growth 12%-1% = 11%
- Value: $75K/11% = $682,000

ILLUSTRATIVE

Revenues	$1.2 mm
Net inventory cost	$200K
Other net assets	$10K
Owner's comp	$125K
EBIT	$30K
Pre-tax capital cost	12%
Proj EBIT growth	1%
Value	$626,000

Excess Earnings Method

- Owner's comp is high, so $45K moved to earnings
- Net tangible assets = $210K
- Justification for NTA investment at (9%-1)%= $16.8K
- Excess earnings: $75K – $16.8K = $58.2K
- Value: $210K NTA + $58.2K/(15%-1%) = $626,000

Average of Three Sales – Cash Flow Method

ILLUSTRATIVE

Revenues	$550K
Net inventory cost	$45K
Other net assets	$25K
Owner's comp	$30K
EBIT	$14K
Pre-tax capital cost	12%
Proj EBIT growth	0%
Value	$117K

Cash Flow Method

- Owner's comp is at market, so no adjustment
- Normal EBIT = $14K
- Pre-tax capital cost less expected growth 12%-0% = 12%
- Value: $14K/12% = $117,000
- Actual sales price = $111K

Average of Three Sales – Excess Earnings Method

ILLUSTRATIVE

Revenues	$550K
Net inventory cost	$45K
Other net assets	$25K
Owner's comp	$30K
EBIT	$14K
Pre-tax capital cost	12%
Proj EBIT growth	0%
Value	$121K

Excess Earnings Method

- Owner's comp is at market, so no adjustment
- Net tangible assets = $70K
- Justification for NTA investment at 9% = $6.3K
- Excess earnings: $14K – $6.3K = $7.7K
- Value: $70K NTA + $7.7K/15% = $121,000
- Actual sales price = $111K