

VALUATION observations



Economic and Financial Market Crisis: How does it affect the value of your private business?

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Bailouts... bankruptcies... credit crises... investor panic... Newspapers have been flooded with poor financial news since the term “subprime mortgage” entered our every-day lexicon. The Dow Jones Industrial Average (“DJIA”) lost nearly one-third of its value in 2008. How does the current economic and financial market crisis affect the value of your private business? There are at least four characteristics of today’s marketplace that valuation professionals will take into consideration when valuing your company. The four are fairly related:

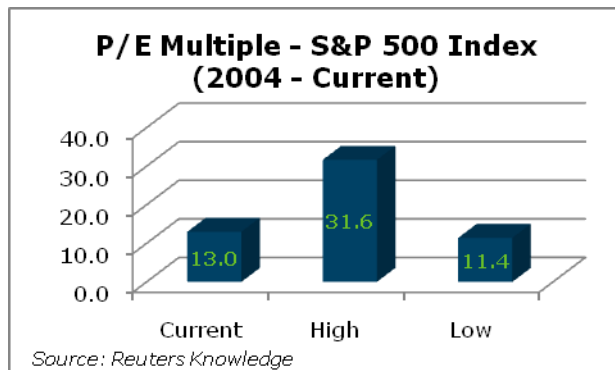
- **Poor Economy / Slowing Demand** – The recent slowing in economic activity reduces the demand for many goods and services. A conspicuous example of this is the fall in oil prices, with the price of crude oil hovering near \$40 a barrel in January 2009 after eclipsing \$140 less than a year earlier. Obviously, some industries are more susceptible to slowing consumer demand than others, and it is up to the valuation expert to make the distinction. While the current economy is harsh for residential construction (quarterly revenue growth of -36.0%, year over

year¹), it has been ineffectual for agricultural chemical makers (growth of 63.8% over the same period¹). For cyclical companies affected by today’s environment, a decrease in consumer demand leads to lower revenues as well as...

- **Increased Uncertainty of Cash Flows** – The instability of the financial markets and the economy creates uncertainty in the eyes of investors, which is detrimental to stock prices. Projected future cash flows or earnings estimates may no longer be a “slam dunk” in the eyes of investors. The more uncertain future cash flows become, the lower the price investors will pay for that investment (or equivalently, the higher the return expected on it). Price-to-Earnings (“P/E”) multiples are a useful investment tool because they measure the price investors are willing to pay for an expected earnings level. As shown in the following chart, the current P/E multiple of the S&P 500 Index is 13.0 (using earnings for the trailing twelve months), near a five-year low.

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- Volatility in Prices of Comparable Companies** – One of the most commonly-accepted approaches to business valuation involves comparing the subject company to publicly-traded companies in the same industry. The stock prices of public companies have experienced nearly unprecedented volatility recently, evidenced by wild swings in the DJIA and the S&P 500. A valuation that considers the multiples of public companies as of January 2009 may look significantly different than a valuation as of January 2008 (or even June 2008).
- Reduced Marketability** – The instability of the financial markets has led to a general fear among investors, many of whom responded by moving wealth from risky investments such as stocks. When more market participants want to sell than want to buy (i.e., supply exceeds demand), prices must decline. Private company investments may be especially susceptible to a decline in

demand, as studies show that investors place a premium on marketability and liquidity during poor economic times.

- Reduced Marketability (Part Two)** - Another factor that has reduced the marketability of private company investments is the recent decline in bank lending. As banks scramble to improve liquidity and strengthen balance sheets during the credit crisis, the amount of money made available to businesses and individuals has declined. Since most large transactions of private company stock occur with the help of bank financing, current developments in the banking industry have harmed the marketability of private companies. Overall, a reduction in marketability leads to a lower business value.


General Conclusion

Clearly, not all businesses are affected by the current crises. Smaller companies may be insulated from the general economy and influenced instead by local factors. Well-managed and stable companies that produce desirable products may continue to report strong revenue and earnings growth. These businesses will continue to attract potential investors. However, it appears from analyzing the above factors that the general economic environment will lead to deflated business values for many companies.

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One Important Caveat

Thankfully, every cloud has a silver lining. The decline in business values, while troubling to owners, can create unique opportunities. Businesses that remain strong may find attractive acquisition targets at lower-than-normal prices. Also, owners of family business who seek to transition their wealth to the next generation can take advantage of relatively low valuations by gifting their shares at discounted prices. For business owners fortunate to be in one of those situations, now may be the time to contact your valuation expert. 

Silver Lining: Market conditions are extremely favorable for acquisitions or wealth transfers.

i - Source: Yahoo Finance.

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