Enhancing the Value of Your Business

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50 Years of Service
Chamber of Commerce
Cayman Islands ★ 1965-2015

MINISTRY OF
FINANCIAL SERVICES,
COMMERCE & ENVIRONMENT
CAYMAN ISLANDS GOVERNMENT

Some Principles of Good Business

* Vision
* Perspective
* Effective Leadership
* Innovation

Vision

"Eagles soar, but weasels don't get sucked into jet engines."
Steven Wright

Perspective

"Right now, this is a job. If I advance any higher, this would be my career. And if this were my career, I'd have to throw myself in front of a train."

Jim Halpert, The Office

Effective Leadership

"The key to being a good manager is keeping the people who hate you away from those who are still undecided."

Casey Stengel

Innovation

"If I had asked people what they wanted, they would have said faster horses."

Attributed to Henry Ford

Why Should You Care?

* Wealth and retirement planning
* Succession planning
* Estate Planning
* Share sales
* Financial Reporting
* Litigation
* Other transactions

Basic Definition of a Business

a. A commercial or industrial enterprise ***and the people who constitute it***

b. An organization operated with the objective of making a profit from the sale of goods or services

c. An enterprise, commercial entity or firm, in either the private or public sector, concerned with providing products or services to satisfy customer requirements

Real World View

"A group of individuals with a plan (strategy) incorporating systems and procedures to efficiently utilize the tangible and intangible assets they have available to meet the needs and wants of their identified customer base."

American Society of Appraisers

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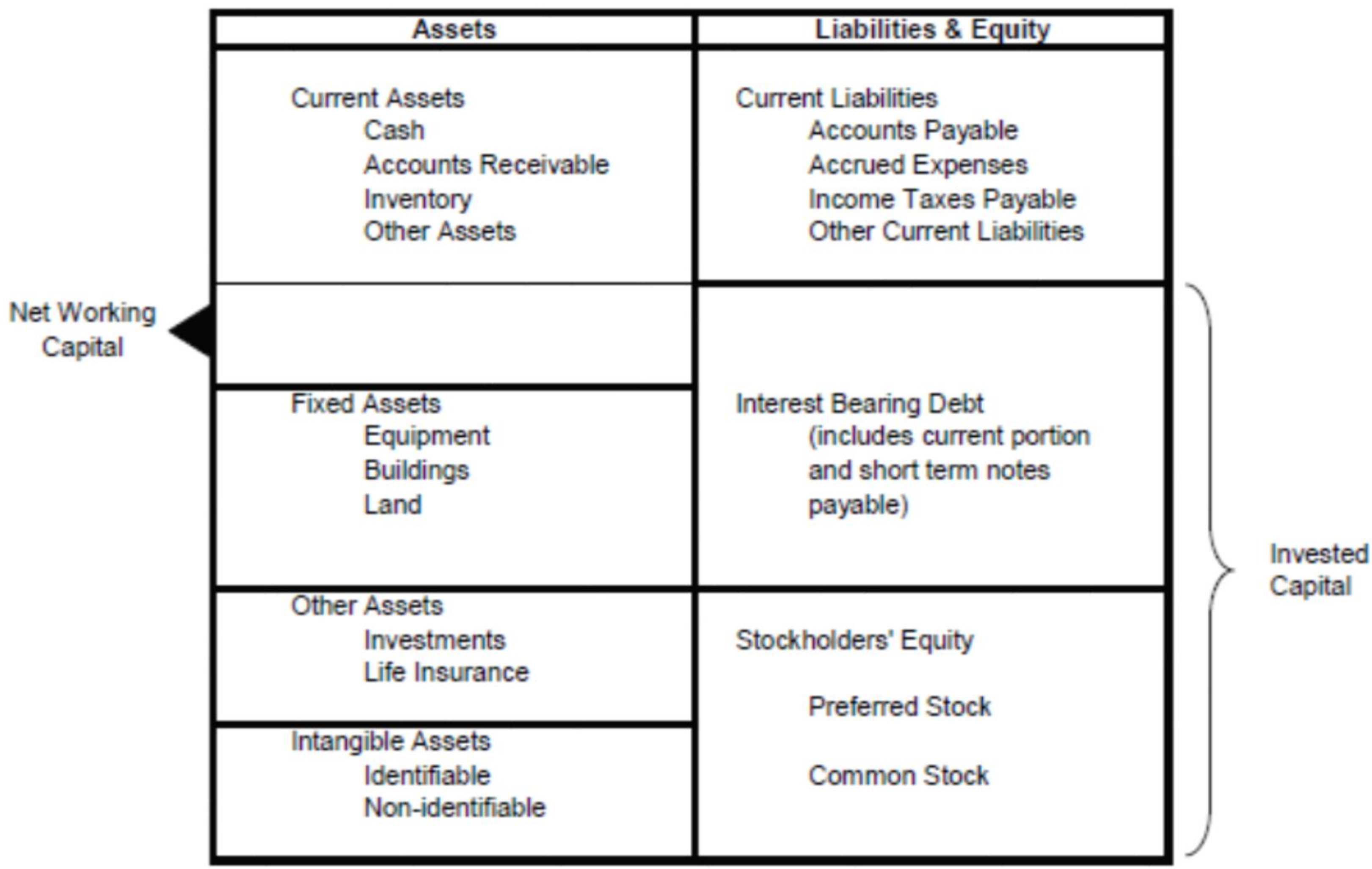
Components of a Business

* Strategy
* Systems
* People
* Tangible and Intangible Assets

Real World View

Highly successful businesses have the ability to get the most out of the manageable parts – the business strategy, systems and people.

Structure of a Business



Net Working Capital

* Current Assets Less Current Liabilities

* Cash and short-term assets expected to be converted to cash within a year less short-term liabilities. ***Businesses use net working capital to measure cash flow and the ability to service debts. A positive net working capital indicates that the firm has money in order to maintain or expand its operations.*** Net working capital tends not to add much to the business' assets, but helps keep it running on a day-to-day basis

Invested Capital

* A combination of all equity and long term debt.
* All of the capital invested by both the equity shareholders and the financiers that create the value of the Enterprise.
* Invested Capital always equals the total value of the assets. (Net Working Capital Plus Non-Current Assets)
* Also referred to as Enterprise Value
* This is not the value of your equity.

Intangible Assets

- **Identifiable Intangible Assets** can include
  - Copyrights, Patents and trademarks
  - Brand, Customer Base, Franchise Agreements
  - Designs, technology, software
  - Contracts, leases, rights, agreements
  - Assembled plant
  - Assembled workforce
  - Etc.

Intangible Assets

* **Unidentifiable Intangible Assets**

  - Everything else

  - Usually caught up in "Goodwill"

  - There are types of goodwill that can be identified, such as "personal goodwill"

  (not necessarily a good thing)

Are you a Going Concern?

- A going concern is an enterprise that is assumed to (or should) continue operations into the foreseeable future.
- If the value of the enterprise is equal to, or less than the value of the net assets, the assumption is "liquidation".
- The determination of which is true, is done by valuing the business based on its income.

How Businesses Are Valued

* Asset Approach (or Cost Approach)
* Market Approach
* Income Approach

Asset Approach Methods

* Adjusted Net Assets Method

  FMV of the total assets less FMV of total liabilities

  Usually does not capture goodwill

  Considered to be a "floor value", and most applicable when a business should be liquidated

Market Approach

Guideline Public Companies Method

Compares P/E ratios of publicly traded companies in the same industry

Guideline Transaction Method

Compares multiples paid for similar privately held companies (Price/Sales, or Price/Discretionary Earnings)

Income Approach

Capitalization of Earnings Method

Cash Flow divided by Cap Rate

Discounted Cash Flow Method

Discounted Present Value of projected future cash flows

Market and Income Approaches Both Dependent on Income

If the value of the income stream, when capitalized, is more than the value of the assets (less liabilities), the enterprise should continue as a going concern.

If the value of the income stream when capitalized is less than the adjusted net assets, then the company may as well be liquidated.

Five Solid Business Practices for Enhancing Business Value

* The importance of solid financial statements
* Keeping **business *business*** and **personal *personal***
* Understanding benchmark ratios and margins in your industry
* Using leverage optimally and responsibly
* Moving personal goodwill to your team and your company

Maintain Solid Financial Statements

* Start with solid accounting
* Generally Accepted Accounting Principles (GAAP), IFRS, etc.
* Generally means accrual accounting
* Have your books reviewed by CPA or CA so that there is someone that can be called for questions by interested buyers
* Remember the 3 statements that need to be correct:
* Balance Sheet, Income Statement and Cash Flow Statement

Maintain Solid Financial Statements Accrual Accounting

* Revenues are accrued when owed; i.e. invoices are generated when work is completed
* Expenses are accrued when owed; i.e. bills are entered before necessarily being paid
* Credit card transactions when they are posted; not paid
* Net income not distributed is converted to retained earnings on the balance sheet

Maintain Solid Financial Statements Accrual Accounting

* Money owed to you creates an asset called Accts. Receivable
* Money you owe creates a liability called Accts. Payable
* Unpaid payroll booked as a liability
* Unpaid shareholder distributions booked as a liability
* Shareholder capital can be equity or liability (will it be paid back?)

Maintain Solid Financial Statements Accrual Accounting

* Create asset accounts for each asset held
* Depreciate according to normal schedules (expense)
* Real Estate should be at market value
* Notes payable booked as a liability (not expense)
* Inventory should be FIFO not LIFO

Separating Personal from Business

* Running personal assets and expenses through your company's books distorts the value of the company
* Lifestyle Businesses are typically run down until profit is nil, then shareholder has to kick in to keep running
* Difficult to analyze company ratios
* No tax advantage in Cayman
* Remove non-operating assets/liabilities
* Real estate and vehicles can be leased from owner

Business Ratios

* Liquidity / Solvency Ratios
* Efficiency Ratios
* Operating Ratios
* Leverage Ratios

Liquidity Ratios

Current Ratio (Current Assets / Current Liabilities)

The higher the ratio, the greater the cushion between the firms obligations, and their ability to pay them

Liquidity Ratios

Receivables Turnover (Sales / Receivables)

* This ratio measures the number of times trade receivables turn over during the year.
* The higher the turnover of receivables, the shorter the time between sale and cash collection.
* Divide 365 by ratio to get average days receivable.

Liquidity Ratios

Receivables Turnover (Sales / Receivables)

For example, a company with sales of $720,000 and receivables of $120,000 would have a sales/receivables ratio of 6.0. This means receivables turn over six times a year. If a company's receivables appear to be turning more slowly than the rest of the industry, further research is needed and the quality of the receivables should be examined closely.

Liquidity Ratios

Inventory Turnover (Cost of Sales / Inventory)

Measures the number of times inventory is turned over during the year.

High—can indicate greater liquidity or superior merchandising.

Conversely, it can indicate a shortage of needed inventory for sales.

Low—can indicate poor liquidity, possible overstocking, or obsolescence.

On the positive side, it could indicate a planned inventory buildup in the case of material shortages.

Efficiency Ratios

Working Capital Turnover (Sales / Working Capital)

Working capital is a measure of the margin of protection for current creditors.

Relating sales to the underlying working capital, measures how efficiently working capital is being used.

Efficiency Ratios

Working Capital Turnover (Sales / Working Capital)

Low ratio (close to zero)—A low ratio may indicate an inefficient use of working capital.

High ratio (high positive or high negative)—A very high ratio often signifies overtrading, which is a vulnerable position for creditors.

Operating Ratios

* **Gross Margin** (Gross Profit / Sales)
* **Operating Margin** (EBITDA / Sales)
* **Return on Assets** (Net Income / Total Assets)
* **Return on Equity** (Net Income / Equity)

Leverage Ratios

* Long Term Debt / Equity
* Total Debt / Invested Capital
* Total Debt / Total Assets
* Interest Coverage (EBIT / Interest Exp.)

Using Leverage Optimally and Responsibly

* Leverage means getting a greater return than the cost of capital
* Most small businesses do not exceed 35% - 50% LTD/Invested Capital
* Use leverage to increase working capital for expansion or purchasing new materials

Using Leverage Optimally and Responsibly

* Rules of Thumb: New borrowings should result in Current Ratio of no more than industry norm (around 1.5-2.0 for many industries)
* The increase in sales due to new borrowings should double the amount of new borrowings

Using Leverage Optimally and Responsibly

SAMPLE OF INCREASING LEVERAGE TO INCREASE VALUE

Sales				$1,000,000	
Cost of Sales		70%		$700,000	
Operating Expenses		25%		$250,000	
EBITDA				$50,000	5.0%
Interest Expense		1.5%	12%	$15,000	
Net Income				$35,000	3.5%
Total Assets		100%		$350,000	(10% ROA)
Long Term Debt		35%		$122,500	
Equity		65%		$227,500	
Invested Capital		100%		$350,000	
Return on assets	10%				
Return on Debt	29%				
Return on Equity	15.4%				

Using Leverage Optimally and Responsibly

New Debt				$100,000	
Sales				$1,200,000	(adds double new debt)
Cost of Sales		70%		$840,000	
Operating Expenses		21%		$250,000	
EBITDA				$110,000	9.2%
Interest		2.3%	12%	$27,245	
Net Income				$82,755	6.9%
Total Assets				$450,000	
Long Term Debt				$222,500	49%
Equity				$227,500	
Invested Capital				$450,000	
Return on Assets	18%	*Better*			
Return on Debt	37%	*Better*			
Return on Equity	36.4%	*Better*			

Getting Rid of Personal Goodwill

- Businesses are discounted for "Key Man", or personal goodwill
- Delegate customer relationships to managers
- Create a Succession Plan

Succession Planning

* Sometimes the only exit plan is your employees.
* Shares can be sold through incentive compensation earmarked toward paying debt for shares, etc.

Q&A

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