GRAIN ELEVATOR AND FEED MILL ASSET VALUATIONS – WHAT IS MY BUSINESS WORTH?

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OVERVIEW - Methodologies to Value the Company

There are three basic Approaches to value a Company: 1) the Asset approach; 2) the Income approach; and 3) the Market approach

Asset based approach

The Most appropriate valuation approach for Companies that are considered holding entities (for example, real estate or Companies with high asset values and modest earnings) is the Asset Approach. This approach requires the adjustment of the Company's book value of its assets and liabilities to their Fair Market Value. Often times, it is necessary to get formal appraisals of equipment, land and other assets the Company holds.

The Asset approach is often the correct method for an operating entity if the company has modest or negative earnings and a significant net asset value. This is most often the case for Grain Elevator and Feed Mill operations that have been in existence for many years if not decades. This is because a business owner requires a return on its investment in the fixed assets. As an example, if a company has net asset value of $5 million and the owner requires a return on its assets of 10%, it would be necessary for the Company to earn $500,000 JUST TO PROVIDE A RETURN ON THE INVESTMENT IN THE ASSETS. Unless the Company earns more than $500,000 (in this example) the return on the assets will be insufficient to cover the asset investment and there will be no earnings available to generate Goodwill (also known as Blue Sky). The Income approach discussion below addresses this issue in more detail. In the agricultural environment, because there is often very significant net asset value in the Company, and the earnings are relatively modest in comparison, there is often NO goodwill or blue sky in this type of business.

Income based approach

There are two general income approaches to valuing Companies – The Capitalized Earnings approach which looks at historical earnings, and the Discounted Cash Flow approach which looks at future earnings to arrive at business value.

Capitalized Earnings (historical earnings) **-** This approach involves looking back historically for indication of future performance.

Discounted Cash Flow (DCF) **-** The DCF approach involve the use of forward looking requiring forecasts to value the Company. This approach is typically used when historical earnings are not representative of future expectations. In order to use this approach, you need

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to have the ability to accurately forecast future earnings. Forecasts are typically management's responsibility.

Market based approach – Used for Operating entities

The Market based approach looks to actual transactions in the existing Company or the marketplace to serve as a proxy for the value of the Subject Company. It is often very difficult to use this method for Grain Elevators and Feed Mills due to the lack of "comparable" transactions. Issues to address in this approach include:

- i. Prior transactions of subject company ownership interests
    1. How old is the prior transaction?
    2. Arms' length?
- ii. Prior transactions of similar companies
    1. Synergies?
    2. Reason for transaction?
    3. Availability of data?
    4. Age of transaction?
    5. Comparability of transaction?
- iii. Information from publicly traded guideline companies
    1. Concept is that you find comparable companies and use their P/E or other pricing multiples as proxies for your subject company's multiple
    2. Need to adjust these multiples for differences in Size; Growth outlook; etc.
    3. Usually for valuing larger companies
    4. Requires enough COMPARABLE data to be relevant
        - a. Garbage in, Garbage out
        - b. Probably most misused approach by casual valuators
        - c. Adjustment for differences in size, e.g., can be as high as 50% or more

CONCLUSION: BECAUSE OF THE LARGE NET ASSET VALUES IN MOST OF THESE MATURE COMPANIES, FOR MOST FEED MILLS OR GRAIN ELEVATORS, THE ASSET APPROACH WILL BE USED TO DETERMINE THE FAIR MARKET VALUE OF THE OVERALL BUSINESS.

Key Valuation Drivers – How can the business owner increase the value of the business?

There are several key drives of value for all businesses, including Grain Elevators and Feed Mills. By knowing what these drivers are and how they impact value, it is possible to focus management's long-term decisions on these drivers to enhance value of the Company down the road.

1. Earnings

- i. It is important to choose an earnings stream that is relevant to your company/industry. Heavy investments in hard assets; or very high or very low debt levels can dictate which earnings stream is appropriate.

1. Net Income (includes consideration of interest expense, income taxes, and non-cash items such as depreciation and amortization)
2. EBITDA (Earnings Before Interest Taxes Depreciation and Amortization)
3. EBIT (Earnings Before Interest and Taxes)
4. Cash Flow (eliminates non-cash items such as Depreciation)

ii. Whatever earnings stream is used, it must match the multiples applied to those earnings arrived at from market data.

b. Multiple

i. Public Company/Transactional data
1. Need to be sure they are truly comparable
2. Must be applied correctly, each database has different items that need to be added to the calculated value (such as cash, fixed assets, etc.) **THIS IS OFTEN DONE INCORRECTLY AND CAN RESULT IN HUGE SWINGS/ERRORS IN VALUE.**
3. Is a company 50x larger than yours really comparable?
4. If the "comparable" company is diversified into many areas and your company is in one niche, is that a comparable company?

ii. BuM (Build-up Method) Valuator builds up the risk rate using empirical data

Risk Free Rate	4%	4% (Treasuries)
Equity Risk Premium	5%	5% (SBBI)
Size Premium	6%	6% (SBBI)
Specific Risk (JUDGMENT)	5%	5% (Valuator)
Discount Rate (for DCF)	20%	20%
LESS Growth Rate	(3%)	(8%) (Valuator)
Capitalization Rate	17%	12%
Multiple (1/Cap. Rate)	5.9	8.3

c. Growth – One of the biggest value drivers in a valuation

i. Can dramatically impact value

ii. Looking at LONG TERM –
- Should it be at least equal to inflation?
- Can it be double digit?
- What happens if growth is not expected to be constant?
- What is the impact on value?

- Multiple (1/Cap. Rate) 5.9 8.3

Multiple (1/Cap. Rate)	5.9	8.3
o Times Cash Flow	$100,000	$100,000
o Calculated Value	$590,000	$830,000

- **In this case, a difference of 5% in growth resulted in a 40% difference in value!!!**

d. Risk (this adjustment has similar impact to value as Growth in many cases)

i. Chosen by Valuator, based on company analysis such factors as:
1. **Client concentration**
2. Volatile Niche
3. Poor Capitalization

4. **Competition**
5. Thin Management

AS A BUSINESS OWNER, YOU CAN CONTROL THE VALUE DRIVERS THAT IMPACT THE VALUE OF YOUR BUSINESS. A LONG-TERM PLAN FOCUSED ON THE KEY VALUE DRIVES AND BUSINESS RISKS WILL HAVE DRAMATIC IMPACT ON VALUE OF THE COMPANY IN THE EYES OF A BUYER.

What is the appropriate Income/revenue definition to us for valuing the Company?

i. **Revenue** Multiple?
    1. What if the subject company is losing money? You get the same value for a profitable company as a company losing money under this approach.

ii. **Earnings**? - There are many different "earnings" metrics.
    1. Are you using "Cash Flow"; "EBIT"; "EBITDA", each one requires a <u>different</u> multiple. For example, applying the same multiple to EBIT and EBITDA will result in a much higher value under the EBITDA calculation than the EBIT calculation, due to the addback of depreciation and amortization, which is often significant.
    2. Do you adjust Earnings for <u>market based expenses such as:</u>
        a. Officer's Compensation - are the officer's over paid/underpaid? If so, the net income reflected is not market earnings. What would an outside owner have to pay to replicate the skills/tasks provided by the officers?
        b. Rent
            i. If the company is leasing from a related party, this rent expense could be higher than market rates, thereby lowering the income, and thus the value.
        c. Other
            i. What do you do about non-operating assets? Is that cash in the business needed for operations, or can it be distributed without impacting earnings? This can have an impact on the value of the company under an earnings method. Non-operating assets are added to the value of the company calculated under the income methods.
    3. Do you reduce earnings for <u>income taxes</u> (C-Corp or S-Corp)?
        a. In valuing a pass through entity, we will typically impute taxes against the net income, even though the entity itself doesn't pay taxes. This will lower the value of the company as compared to not tax imputing. If the agreement is silent on this issue, different appraisers may do this differently.
    4. If using historical data, what weighting do you give each year?

a. Use most recent year?
    i. What if that year is a mountain or a valley? In today's economy, the reliance on the most recent year or even the last 3 years will result in a lower value for the company than is likely warranted, due to lower earnings and often times lower multiples.

    TYPICALLY, A POSITIVE TREND IN EARNINGS WILL CREATE A HIGHER VALUE THAN SPORADIC EARNINGS, OR A NEGATIVE TREND.

b. 5 most recent years?
    i. Weight them equally or other method?
    ii. How do you consider <u>anomalies</u>?
    iii. How do you consider cyclicality within the industry?
    iv. Does the formula require an adjustment for <u>non-recurring items</u>? For example, what if you have a capital gain in the most recent year of $500,000; do you remove that item from earnings? If not, and your multiple is 5, your value is $2,500,000 higher than it probably should be.

5. Does your valuation require a reduction of the debt, or consideration of the equity of the company?
    a. This goes to the issue of comparing apples to apples.
    b. When valuing "invested capital" the value figure includes the debt.
    c. When valuing equity, the debt is removed. Depending on the level and nature of the company's debt, this distinction can be dramatic.

    THIS IS ONE OF THE MOST MISUNDERSTOOD CONCEPTS IN VALUATION. IF YOU ARE USING <u>PRE</u>-DEBT EARNINGS, YOU MUST DEDUCT LONG-TERM DEBT FROM THE CALCULATED VALUE.

Other issues that impact value of the business and cash in the hands of the seller.

1. Is there excess cash or other non-operating assets that can be removed prior to sale without impacting value? If so, you can "clean up the balance sheet" by removing these assets.
2. Do your key people have non-compete agreements? The absence of non-compete agreements for key employees and management can often be a deal breaker. You must have these in place prior to marketing the business or risk losing value in the Company. You give the employees all the leverage if you ask them to sign these after marketing the business.
3. Tax Planning

    The gross sale price is not as relevant as the after-tax proceeds
    Consult your tax advisor regarding:
    - Stock sale versus asset sale

    - Stock sale usually favors the Seller, all other things being equal
    - Buyer may prefer asset purchase to allow for new basis in assets and resulting depreciation expense
- Allocation of asset values – often a key area of disagreement
- Tax impact of non-competes; consulting agreements; etc.

Conclusion

Many Grain Elevators and Feed Mills will be valued based upon the Net Asset Value method, which requires the assets and liabilities to be adjusted to their fair market value.

In the case of a highly profitable Elevator or Mill, there is a possibility that Goodwill exists due to its earnings. In those cases, the management of these key value drivers of the business can pay off dramatically for the seller in the form of a higher sale price.