# Viewpoint on Value


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# How much does human capital add to a company's value?

Human capital is often one of the most valuable — and difficult to replicate — resources that companies own. It includes a trained and assembled group of workers who know how to operate equipment, follow the company's policies and procedures, innovate to build new products and services, and work together as a team to achieve the company's strategic goals. But assigning a dollar value to such intangible assets is a complex task that requires the use of an experienced valuation professional.

## Identifying human capital intangibles

Human capital comes in many forms. The most obvious example is employees on the company's payroll. But it also may include relationships with independent contractors, consultants and celebrities, as well as employment contracts, noncompetes and confidentiality agreements.

Professional licenses may be considered another type of human capital, because they allow professional services firms to conduct business and, therefore, add value. But these licenses can't be transferred to third parties and, therefore, are typically the property of individual practitioners, not the company.

## Applying the cost approach

A logical starting point for valuing an assembled workforce is to estimate the cost to reproduce or replace the company's workers. This estimate includes the costs to recruit, hire and train each level of the company's workforce. Valuators consider such items as:

- Headhunter fees,
- Salaries and benefits of recruitment and training staff,
- Costs of background checks, drug tests and screening exams,
- Relocation fees, moving costs and signing bonuses,
- Classroom materials and fees, and
- Lost productivity of new and existing staff during the recruitment and training processes.

When valuing workforce assets, an important distinction should be made between reproduction and replacement cost. Reproduction cost is the current cost of an *identical* property — in other words, the same number of employees with the same skills, education levels, experience and salary requirements.

Replacement cost is the current cost of employing a *similar* workforce that has the nearest equivalent utility to the existing workforce. Replacements might be younger employees who are willing to perform the work for less money — or fewer employees who are more highly qualified and efficient — than the existing workforce.

In some cases, an appraiser may decide that the company is paying higher labor costs than it should. However, sometimes excessive labor costs arise from union agreements or family commitments and may be unavoidable.

Valuators also should watch out for employees nearing retirement who may need to be replaced soon. If a significant number of key employees are nearing retirement, it could affect the value of a company's workforce.

### Factoring other approaches into the analysis

Although the cost approach is the most common way to value an assembled workforce, the income or market approaches are sometimes used to gauge whether the results of the cost approach make sense.

**A logical starting point for valuing an assembled workforce is to estimate the cost to reproduce or replace the company's workers.**

For example, the value of a professional practice's workforce under the cost approach could be divided by the number of employees to calculate the average value per employee. This amount could then be compared to the average net realizable billable hours per employee to impute the firm's return on human capital.

Assembled workforces aren't normally sold as separate assets. So the market approach is rarely used to value human capital. But an appraiser might compute the value of a workforce under the cost approach as a percentage of the company's total value and ask: Would a buyer be willing to pay this much to acquire these assets? Or would a seller be willing to give up these assets for this amount?

## Top reasons to appraise human capital assets

Mergers and acquisitions (M&A) are often driven by the buyer's desire to add skilled employees and other intangible assets quickly. Although an assembled workforce isn't a separately identifiable intangible asset when accounting for business combinations under Generally Accepted Accounting Principles, there are several situations that call for the value of human capital-related assets to be separately quantified.

In M&A, the value of human capital is relevant when establishing the selling price. An assembled workforce that's been acquired is also an amortizable intangible asset for federal income tax purposes. And, when testing for goodwill impairment after an acquisition, it may be necessary to separately value the company's assembled workforce to capture the value of only goodwill.

Beyond M&A, the value of an assembled workforce may be used to identify business goodwill in states that bifurcate business and personal goodwill when splitting up marital estates in divorce cases. Or it may be needed to lower a company's property tax base, where intangibles are excluded from ad valorem property tax assessments.

Litigation involving alleged violations of contractual obligations — such as the terms of employment contracts, noncompetes or celebrity endorsement agreements — also may warrant damages calculations based on the value of human capital-related intangibles.

### Seeking objective input

People are critical to a company's success. But valuing human capital involves many moving pieces, including an in-depth understanding of today's human resource guidelines, employment trends and market compensation rates. A valuation professional can provide objective market data and financial analysis to help support a workforce appraisal. ●

# Ready to grow

## Valuators can help evaluate internal and external investment alternatives

Now that the economy is picking up, owners and managers may be brainstorming ways to grow the business. Most companies have limited cash reserves, borrowing capacity and manpower and, therefore, can't pursue every idea. So valuators can provide objective insight into which growth strategies make the most sense from a financial perspective — rather than relying on gut instinct.

### Grow organically

Management can take the slow and steady path by stepping up sales themselves. Internal growth strategies include building a new plant, purchasing new machinery, developing a new product or service, or expanding into new markets.

Building from within isn't without drawbacks. Management must devote significant time to marketing and selling, which means there's less time for normal operations. This can be especially disruptive for small businesses that rely on a few key individuals. Likewise, integrating new equipment or facilities can consume time at the expense of existing sales and customer service.

Additionally, new products might cannibalize existing ones, or a new target market might reject a product extension. Preliminary tests — free trials, surveys and focus groups — are inexpensive ways to avoid costly marketing miscalculations.

### Pursue outside growth

One fast track for growth involves buying another business. An acquisition typically provides assets and an established track record, including immediate cash flow, an assembled workforce, a pre-existing client base and customer referrals.

Business combinations make the most sense if the value of the combined entity is greater than the sum of its parts. So, acquisitions should create value via economies of scale, operating synergies and cross-selling opportunities. Competitors are obvious acquisition candidates.

Acquisitions don't always pan out, however. Potential reasons for failure include incongruent corporate cultures and seller misrepresentations. Successful transitions usually require the seller's ongoing efforts. In-depth due diligence also can minimize acquisition risk.

When mergers or acquisitions seem too risky, valuators may recommend joint ventures and other contractual relationships with other companies — such as licensing and franchising — to allow a client's business to grow with minimal capital infusion. By starting slowly, two organizations can test their congruence and, if compatible, add incremental layers over time.

### Crunch the numbers

When a company is prioritizing and selecting growth alternatives, projected financial statements are useful tools. Valuators can help management project financial results under a variety of alternative growth strategies.

Typically, projections start with an expected percentage increase in sales. Then, the growth rate flows through to other items that are related to sales, such as inventory, receivables, payables and variable expenses. Thorough projections depict all three financial statements: the income statement, balance sheet and cash flow statement. Historical results can provide an important frame of reference when management is reviewing projections.

### Dig deeper

One problem with financial projections is that they ignore the time value of money. That's because, by definition, they describe what's likely to happen given a set of circumstances. So it's difficult to compare detailed projections against other investments a business might be considering. Other financial tools generate comparative metrics, such as:

**Accounting payback period.** This is the number of years a project will take to recoup its initial cost. Projects that pay back sooner typically are considered less risky than those with longer investment horizons.

**Net present value (NPV).** Here, future cash inflows and outflows are discounted to present value and added up. If a project has a positive NPV, it's generally worth pursuing.

**Internal rate of return (IRR).** This is the rate at which a project's NPV equals zero. Companies generally pursue investments with the highest IRR. Alternately, some companies have a minimum "hurdle rate" that projects must exceed to justify pursuing.

Valuators can help management project financial results under a variety of alternative growth strategies.

Sometimes the results of these metrics conflict with each other. A valuator can help explain any discrepancies, as well as evaluate the qualitative factors that could sway management's decision making.

### Stay objective

It's common for management to become emotionally invested in their growth plans. Outside financial experts help keep owners and managers grounded and objective. Valuators understand how to project future financial results under multiple investment scenarios and factor the time value of money into their analyses, so they can provide valuable insight and objective appraisal expertise in times of growth. ●

## Visual aids: A picture can be worth 1,000 words

Business appraisers who serve as expert witnesses in court face two daunting tasks: They must capture the attention of a judge or jury and make complex financial analyses easy to understand. That's easier said than done after the trier of fact already has listened to hours of testimony in commercial litigation. Impactful visual aids can help break up the monotony and drive home key points in an expert's oral testimony and written reports.

### Tips for maximum impact

Many people are visual learners, so oral testimony alone may not be enough to enable them to understand complex issues, such as discounted cash flow

analyses or profit trends. Experts who supplement their analyses with pictures often leave a lasting impression.

Today, most courtrooms are equipped with technology that allows experts to display visual aids from a computer directly to a pull-down or pop-up screen. But technology is known to fail, so experts should always come to court with a hardcopy or transparency back-up plan. Other tips to get more from visual aids in court include the following:

**Limit the number.** Experts shouldn't use visual aids as a crutch or a replacement for verbal testimony. Instead, they should reinforce the expert's oral testimony. As a general rule of thumb, select five or fewer graphics that illustrate key strategic points. During deposition or direct examination, ask the expert to explain each graphic in detail, rather than leaving judges and jurors to interpret the pictures themselves.

**Use the appropriate visual tool.** Pick a layout that matches the data you're trying to explain. For example, a line graph might be appropriate to demonstrate a relationship between two variables, such as price and earnings or sales trends over time. A pie graph can be used to show product or customer mix. Tables can be used to highlight lists of important facts. Formulas can be written out to explain how an appraiser arrived at a particular conclusion.

**Keep it simple.** Avoid visual aids that are cluttered with too many colors and symbols or make too many points. They can be confusing and do more damage than good. Each graph or image should emphasize one key point — maybe two — but no more.

Some judges and jurors could be color-blind, so stick with primary colors or black-and-white images. And make sure that any fonts used are large enough for people with 20/60 vision to read from the bench or juror box without their glasses.

## Visual aids in written reports

Another important placement for visual aids is inside the written appraisal report. During deliberations, judges and jurors may refer back to an expert's report to jog their memories. The same guidelines apply for visual aids in written reports as during oral testimony. However, appraisers may decide to include more visual aids in their reports than they would present during trial.

Some experts reserve pictures for the appendixes to their reports. But increasingly valuators insert visual aids throughout their reports to break up multiple pages of complicated financial explanations.

Technology is known to fail, so experts should always come to court with a hardcopy or transparency back-up plan.

## Request for more visual aids

Before heading to trial, it's important for attorneys to talk to expert witnesses about direct examination questions, key points and potential sources of confusion. If your expert isn't planning to use visual aids, you might consider requesting a few to bolster the effectiveness of his or her oral testimony and written reports. ●

Back to basics

# Getting a handle on terminal value

One of the most popular ways to value a business is the discounted cash flow (DCF) method. This technique derives value from a company's expected future cash flow. But many businesspeople don't realize that 50% (or more) of the value under this method typically resides in the present value of the subject company's "terminal value." Because so much is riding on this number, it's important to understand how it's calculated.

## What is terminal value?

Also known as residual value, terminal value is "the value as of the end of the discrete projection period in a discounted future earnings model," according to the *International Glossary of Business Valuation Terms.*

Terminal value is typically measured using the capitalization of earnings method. This technique is based on the assumption that cash flow eventually will stabilize in the final year of the projection period. However, this is also the time period that's subject to the greatest margin for error because it's the furthest into the future.

## What factors into the model?

Under the capitalization of earnings method, the Gordon Growth Model is often used to measure terminal value. This model is based on a ratio, in which the numerator equals cash flow in the final projection period times 1 plus the long-term sustainable growth rate. The denominator equals the discount rate minus the long-term sustainable growth rate.

Terminal value equals expected future cash flow (the numerator) divided by the capitalization rate (the denominator). Because it's in both the numerator and the denominator, the long-term sustainable growth rate can have a significant impact on the terminal value and, therefore, the value of the company.

Terminal value must also be discounted to its present value. Then it's added to the net present value of cash flows over the discrete projection period to arrive at the value of the business under the DCF method.

## How can terminal value be tested?

A sanity check can help support a valuator's estimate of terminal value. For example, it's possible to impute pricing multiples from the valuator's estimate of terminal value. Valuators can then compare the implied pricing multiples based on terminal value to average pricing multiples from comparable transactions involving similar companies in recent years.


There may be cause for concern if, say, a company's terminal value generates a price-to-revenues multiple of 3.0 and comparable transactions during the last 12 months indicate an average price-to-revenues multiple of 0.8.

## Who can help evaluate terminal value?

If terminal value has you confused, you're not alone. Fortunately, you can contact an experienced valuation professional for more information. ●

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**John M. Leask II (Mac), CPA/ABV, CVA**, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

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More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

*To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at* ***203 - 255 - 3805.***
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If you have a business valuation problem, Mac is always available to discuss your options — at no charge.