

CHAPTER TWO

MERGERS AND ACQUISITIONS



NACVA/IBA Training Center Special Purpose Valuations Mergers & Acquisitions

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Business Valuation for Mergers and Acquisitions

Valuation for M&A Overview

- The purpose of an M&A Valuation is to establish a price at which a buyer is willing to buy and a seller is willing to sell.
- There are several fundamental differences between traditional business valuation engagements and valuation for M&A purposes.
- Like a CPA audit report, a traditional valuation report uses a set of general principles to produce a report that covers a discrete point in time.
- Most valuations are performed with a specific purpose in mind
 - Estate and Gift Tax planning
 - Fairness Opinions
 - Purchase Price Allocations
- In an M&A engagement however, the sophistication of the process or the style of the report are of little value if the underlying assumptions are flawed.
- Given its potential impact on the transaction price, the valuation component of an M&A engagement must be an integral part of the overall process.

Business Valuation for Mergers and Acquisitions

Investment Banker Role

- Assist in developing price and structure of a deal
- Help with the packaging process
- Confidentially screen prospects
- Perform some initial due diligence work
- Act as a buffer during the negotiation process
- Mediate disputes over pricing and terms

Payment for Valuation Services

- Contingency or "success fee"
- Flat fee
- Hourly
- May be included free as part of a deal to perform more services

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AICPA Standards for Valuation Reports

1. Standards that apply to all Valuation Engagements
 - a. Standards for Consulting Services
 - b. Standards of Professional Conduct
2. Standards that may apply to Valuation Engagements, depending on circumstances
 - a. Standards on Reporting on Historical Financial Information
 - b. Standards on Financial Forecasts and Projections
 - c. Quality Control Standards

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AICPA Standards for Valuation Services

The AICPA has set forth standards which are directly applicable to M&A Valuations. Included in these standards is a clear distinction between a **Valuation Engagement** and a **Calculation Engagement**.

Valuation Engagements

- Analyst applies any appropriate valuation methods
- Results are expressed as Conclusion of Value
 - Can be expressed either as a single amount or a range of values

Calculation Engagements

- Valuation Methods are determined in discussions between analyst and client
- Value is calculated in compliance with a client agreement
- Results are expressed as Calculation of Value
 - Can be expressed either as a single amount or a range of values
- Calculation engagements are most commonly used for M&A Transaction Purposes

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Calculation Engagements

In performing a calculation engagement, the valuation analyst should consider, at a minimum, the following:

- Identity of the client
- Identity of the subject interest
- Whether or not a business interest has ownership control characteristics and its degree of marketability
- Purpose and intended use of the calculated value
- Intended users of the report and limitation on its use
- Applicable standard of value
- Sources of Information used in the calculation engagement
- Valuation approaches or valuation methods agreed upon with the client
- Subsequent events, if applicable

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Standard of Value

Fair Market Value - the price at which the property would change hands between a willing buyer and a willing seller when the former is under no compulsion to buy and the latter is under no compulsion to sell, both parties having reasonable knowledge of the relevant facts. This definition is commonly used by the IRS, the courts, and business valuation firms. This definition assumes a hypothetical arm's length sale without regard to a specific buyer.

Fair Value - The amount at which an asset (or liability) could be bought or sold in a current transaction between willing parties, that is, other than in a forced liquidation sale. Fair Value is most commonly used in SFAS 141 and SFAS 142 valuations regarding purchase price allocations and treatment of goodwill.

In terms of M&A transactions, there is no specific standard of value that an analyst is necessarily bound by, although it is common for analysts to calculate a value that very closely resembles Fair Market Value. Often times, the standard of value in an M&A transaction is known as Deal Value.

Horizontal lines for notes.

Business Valuation for Mergers and Acquisitions

Financial Statement Analysis

Balance Sheet

Balance sheet numbers to use often vary depending on the subject company's industry. As is the case with the analysis of all financial statements, it is important to look at multiple years to evaluate the company over time. Common balance sheet indicators include:

- Current Assets
• Net Fixed Asset Growth
• Net Trade Cycle
• Interest-Bearing Debt
• Non-operating Assets

For M&A purposes, the balance sheet does not provide much insight into how much a company may be worth, with the exception of interest-bearing debt. A potential buyer will likely be far more concerned with the profitability and growth prospects for a company rather than the condition of the company's balance sheet.

Horizontal lines for notes.

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Financial Statement Analysis

Income Statement

The Income Statement contains several items that can be used to help determine the value of a company. Reported net income, although it may be the first number a potential buyer looks for, is not necessarily the best metric by which to measure a company's performance. Important income statement items include:

- Net Sales
• Gross Margin
• Operating Income
• Interest Income / Expense
• Net Income

Horizontal lines for notes.

Business Valuation for Mergers and Acquisitions

Financial Statement Analysis

Adjustments to Historical Financial Statements

Reported financial statements often do not reflect a company's normalized performance. As such, various adjustment to these financial statements need to be made, including:

- Non-operating Adjustments
• Non-recurring Adjustments
• Control Adjustments

For M&A purposes, the primary goal of these adjustments is to arrive at a company's normalized EBITDA, as debt-free multiples are often used by buyers as a primary check for reasonableness of a selling company's asking price.

Horizontal lines for notes or calculations.

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Valuation Methods

Income Approach

- Two Primary Methods
• Single Period Capitalization
• Multiple Period Discounting

Horizontal lines for notes or calculations.

Business Valuation for Mergers and Acquisitions

Valuation Methods

Market Approach

- Two Primary Methods
• Guideline Public Company Method
• Guideline Transaction Method

Horizontal lines for notes or calculations.

Business Valuation for Mergers and Acquisitions

Valuation Methods

Income Approach

- Value of a company is estimated based on earnings capacity of that company
- Two Primary Methods
 - Single Period Capitalization
 - Use if a company's current level of operations is believed to be representative of future operations, and
 - The company is expected to grow at a relatively stable and modest rate
 - Multiple Period Discounting
 - Use when company growth is expected to vary in future years, or
 - Company has prepared projections for future performance
- For M&A purposes, a multiple period discount model may be most appropriate, as potential investors may be concerned with specific growth prospects in future years for an acquisition target.

Business Valuation for Mergers and Acquisitions

Valuation Methods

Income Approach – Discounted Cash Flow Method (DCF)

- Obtaining Projections
 - Can use company prepared projections, or
 - Analyst built projections based on industry trends and discussions with management
- Accurate projections of sales are key as sales will frequently be a primary driver of the remainder of the DCF model.
 - Project growth rates rather than actual amounts
 - Use discussions with management and past performance to mold accurate projections

Business Valuation for Mergers and Acquisitions

Valuation Methods

Income Approach – Discounted Cash Flow Method (DCF)

- Gross Profit and Operating Expenses are often expressed as a percentage of sales.
 - Can use specific growth rates for these items to reflect specific company projections
- Capital Expenditures and Depreciation can be projected based on historical levels and management's expectation for future capital requirements.
 - In residual year of projection, capital expenditures should exceed depreciation by the long term growth rate to represent growth into perpetuity
- Net Working Capital can be forecast as a percentage of sales or grown at a rate similar to sales.

Business Valuation for Mergers and Acquisitions

Valuation Methods

Income Approach – Discounted Cash Flow Method (DCF)

Weighted Average Cost of Capital (WACC)

- To determine a discount rate applicable to the calculated cash flows, it is necessary to calculate a cost of capital (the WACC). The WACC is comprised of two parts, a cost of debt and a cost of equity. The WACC can be calculated as follows:

$$WACC = K_d \times (D/(D+E)) + K_e \times (E/(D+E))$$

Where:

K_d = After Tax Cost of Debt

K_e = Cost of Equity

D = Book Value of Debt

E = Market Value of Equity

$$K_d = \text{Pre-Tax Cost of Debt} \times (1 - \text{Tax Rate})$$

$$K_e = R_f + \beta \times R_m$$

Where:

R_f = Risk-Free Rate (long-term Treasury bond)

β = Target Beta

R_m = Market Risk Premium

Business Valuation for Mergers and Acquisitions

Valuation Methods

Income Approach – Discounted Cash Flow Method (DCF)
Weighted Average Cost of Capital (WACC)

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WACC = K_d x (D/(D+E)) + K_e x (E/(D+E))

Where:

- K_d = After Tax Cost of Debt
K_e = Cost of Equity
D = Book Value of Debt
E = Market Value of Equity

K_d = Pre-Tax Cost of Debt x (1 - Tax Rate)
K_e = R_f + beta x R_m

Where:

- R_f = Risk-Free Rate (long-term Treasury bond)
beta = Target Beta
R_m = Market Risk Premium

Horizontal lines for notes or calculations.

Business Valuation for Mergers and Acquisitions

Valuation Methods

Market Approach – Guideline Public Company Method

- Companies used in this method should be comparable to the subject company in terms of:
- Business description
- Size (in sales)
- Growth of sales and earnings
- Cost structure
- Capital Structure
Once the companies are selected, the valuation analyst must compare the guideline group to the subject company and determine the multiples that will be applied to the subject company. Common pricing multiples include:
- Market Value of Equity ("MVE") to Earnings
- MVE to Gross Cash Flow
- Enterprise Value to EBIT
- Enterprise Value to EBITDA
- MVE to Book Value of Equity
It should be noted that the most important area of comparison is the public company's business description. Companies engaged in different lines of business ultimately experience different risks and trends, and growth can be driven by significantly different factors.

Horizontal lines for notes or calculations.

Business Valuation for Mergers and Acquisitions

Valuation Methods

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- Enterprise Value to EBITDA
- MVE to Book Value of Equity

Horizontal lines for notes or calculations.

Business Valuation for Mergers and Acquisitions

Valuation Methods

Market Approach – Guideline Public Company Method

- Depending on the multiples used, the resulting values may include both enterprise and equity values. If that is the case, the analyst will need to convert all of the resulting values to either enterprise or equity values before concluding on a value for this method.
It should be noted that the most important area of comparison is the public company's business description. Companies engaged in different lines of business ultimately experience different risks and trends, and growth can be driven by significantly different factors.

Horizontal lines for notes or calculations.

Business Valuation for Mergers and Acquisitions

Valuation Methods

Market Approach – Guideline Transaction Method

- Transactions used in this method should be, at a minimum, comparable to the subject company in business description. Other metrics can be used if there is sufficient data.
Once the transactions are selected, the valuation analyst must compare them to the subject company and determine the multiples that will be applied to the subject company. Common pricing multiples include:
Deal Price to Sales
Deal Price to EBITDA
Deal Price to EBIT
Deal Price to Gross Cash Flow

Horizontal lines for notes or calculations.

Business Valuation for Mergers and Acquisitions

Valuation Methods

Market Approach – Guideline Transaction Method

- It should be noted that the most important area of comparison is the public company's business description. Companies engaged in different lines of business ultimately experience different risks and trends, and growth can be driven by significantly different factors.
The multiples to be used are then applied to an appropriate levels of company performance
An enterprise value is selected from the range of values established by the applied multiples
Once selected, the enterprise value needs to be converted to equity value
Subtract Interest-Bearing Debt, Add Cash and Non-operating Assets

Horizontal lines for notes or calculations.

MERGERS AND ACQUISITIONS

Robert. M. Stutz II, AVA, ASA, CM&A

Eric B. Dollin

I. M&A PROFESSIONALS, STANDARDS, AND PROCEDURES

A. PURPOSE

Throughout a valuation professional's career, there will be instances in which a company comes to that professional with the intention of selling his or her business. The following is designed to serve as a stand alone module for professionals who are or may potentially be engaged in a merger and acquisition transaction.

Valuation is one of the most critical steps in the merger and acquisition (M&A) process because it seeks to establish a price at which a buyer is willing to buy and a seller is willing to sell. Because buyers and sellers naturally start at opposite ends of the pricing spectrum, all successful deals must bridge some pricing gap.

There are several fundamental differences between traditional business valuation engagements and valuation for M&A purposes. Like a CPA audit report, a traditional valuation report uses a set of general principles to produce a report that covers a discrete point in time. Most valuation engagements are completed with a specific purpose in mind, such as estate and gift tax planning, fairness opinions, purchase price allocations, and several others. In an M&A engagement, however, the sophistication of the process or the style of the report are little value if the underlying assumptions are fundamentally flawed. Given its potential impact on the transaction price, the valuation component of an M&A engagement must be an integral part of the overall process.

B. INVESTMENT BANKER ROLE

Investment bankers or business brokers act as intermediaries in the M&A transaction. In the simplest of terms, the role of the intermediary is to match buyers with sellers. Normally, this is done on an exclusive basis, meaning the intermediary represents the buyer or the seller, but not both. In addition to the primary role of matching buyers and sellers, intermediaries also provide services that include;

1. Assist in developing price and structure of a deal
2. Help with the packaging process
3. Confidentially screen prospects
4. Perform some initial due diligence work
5. Act as a buffer during the negotiating process
6. Mediate disputes over price and terms

It is common for intermediaries to work under a contingency or "success fee" arrangement that is a percentage of the value of the deal. Other types of pricing arrangement can include hourly consulting fees or flat-rate fees.

To secure the role of intermediary for a buyer or seller, an investment banker will often include in their services the preparation of a calculation report (as will be discussed later) at no additional charge. Investment bankers often include this service in hopes that the success fee that results from successfully selling the client's business will far exceed the fee that could have been collected by charging the client for a calculation report.

C. STANDARDS

The AICPA has established professional standards that generally apply to all services provided by a CPA. Some of these AICPA standards relate to business valuations. The following are examples of various standards that may apply to a CPA preparing a valuation report.

1. Standards that apply to all valuation engagements.
 - a. Standards for Consulting Services
 - b. Standards of Professional Conduct
2. Standards that may apply to valuation engagements, depending on the circumstances.
 - a. Standards on Reporting on Historical Financial Information
 - b. Standards on Financial Forecasts and Projections
 - c. Quality Control Standards

Furthermore, the AICPA has set forth Standards for Valuation Services which are directly applicable to M&A valuations. Included in these standards is a clear distinction between a *Valuation Engagement* and a *Calculation Engagement* (see below).

According to AICPA standards, the type of engagement is established in an understanding with the client. A valuation engagement calls for an analyst to estimate the value of the subject interest. The analyst is free to apply the valuation approaches and methods he or she deems appropriate in the circumstances. The analyst expresses the results of the valuation as a conclusion of value, with the conclusion expressed either as a single amount or as a range.

D. CALCULATION ENGAGEMENTS AND REPORTS

When performing a calculation engagement, the valuation analyst and the client agree on the valuation approaches and methods to be used in addition to the extent of procedures the valuation analyst will perform in the process of calculating the value of a subject interest. This is a significant departure from the methodology described above for a valuation engagement. The analyst then calculates the value in compliance with this client agreement. The analyst expresses the results of these procedures as a calculated value. The calculated value can be expressed as a range or as a single amount. A calculation engagement does not include all of the procedures required for a valuation engagement. For the purposes of M&A valuations, the most likely type of engagement will be a calculation engagement.

In performing a calculation engagement, the valuation analyst should consider, at minimum, the following:

1. Identity of the client
2. Identity of the subject interest
3. Whether or not a business interest has ownership control characteristics and its degree of marketability
4. Purpose and intended use of the calculated value
5. Intended users of the report and the limitations on its use
6. Valuation date
7. Applicable premise of value
8. Applicable standard of value (as will be discussed later)
9. Sources of information used in the calculation engagement
10. Valuation approaches or valuation methods agreed upon with the client
11. Subsequent events, if applicable

A calculation report is the only report that should be used to report the results of a calculation engagement, as described above. The calculation report should identify any hypothetical conditions used in the calculation engagement, including the basis for their use, any application of the jurisdiction exception, and any assumptions and limiting conditions applicable to the engagement. Appendices or exhibits may be used for required information or information that supplements the calculation report. The calculation report should include a section summarizing the calculated value. This section should include the following points:

E. STANDARD OF VALUE

The most common standard of value for business valuations is Fair Market Value. IRS Rev. Rul. 59-60 defines Fair Market Value as the price at which the property would change hands between a willing buyer and a willing seller when the former is under no compulsion to buy and the latter is under no compulsion to sell, both parties having reasonable knowledge of the relevant facts. This definition is commonly used by the IRS, the courts, and business valuation firms. This definition assumes a hypothetical arm's length sale without regard to a specific buyer or seller.

In certain valuation instances, most notably SFAS 141 and SFAS 142 regarding purchase price allocations and treatment of goodwill, the standard to be applied is termed Fair Value. Fair Value is defined as the amount at which an asset (or liability) could be bought or sold in a current transaction between willing parties, that is, other than in a forced liquidation sale.

In terms of M&A transactions, there is no specific standard of value that an analyst is necessarily bound by, although an analyst may calculate a value that very closely resembles Fair Market Value or Fair Value. Often times, the standard of value in an M&A transaction is known as the Deal Value.

It is important to note that the buyer and seller discussed above refer to hypothetical parties. M&A transactions involve specific buyers, often strategic buyers, rather than hypothetical ones. As such, Fair Market Value may not represent an appropriate selling price of a business, as a strategic buyer may often look to acquire a business in the hopes of enjoying potential synergistic benefits that create value in excess of Fair Market Value, and would thus be expected to pay accordingly.

II. FINANCIAL STATEMENT ANALYSIS

The process of evaluating a company's financial statements is essentially the same whether the product is a valuation report or a calculation report. The process of analyzing financial statements involves several processes, as discussed below.

A. BALANCE SHEET ANALYSIS

Balance sheet numbers necessary for a valuation vary depending on the company being valued and the industry in which it participates. In terms of assets, it is important to gauge a company's level of cash, accounts receivable, fixed assets, and any other assets, particularly those that are not related to the company's operations in any way. It is also useful to note the company's total current assets and total assets. An analysis of a company's liabilities should focus on the company's interest-bearing debt and any components of working capital that are evident in current liabilities. The stockholder's equity portion of the balance sheet can provide insight into whether a company is issuing or repurchasing stock and how the company is managing its retained earnings. In addition to looking at the values of each account in the balance sheet, it is necessary to look at these accounts as a percentage of total assets or total liabilities. Financial statements presented as a percentage of a single account are known as Common Sized Financial Statements.

As will be the case with all financial statement analysis, it is important to look at multiple years of past data in order to gain an accurate perspective of the company's current performance and expectations for the future. Particularly in balance sheet analysis, where there is no "bottom line" to provide some insight as to how the company performed, it is important to look at historical trends and evaluate the company's current performance against historical levels. Common trends to look for are as follows:

1. Current Assets

In order to evaluate a company's liquidity, it is important to note current assets relative to any current debt obligations the company may have. If these current assets exceed current debt obligations, the company should have no problem financing its debt in the current year.

2. Net Fixed Asset Growth

If a company's net fixed assets are not growing over time, it may indicate that the company's annual depreciation expense is exceeding its annual capital expenditures, meaning the company may not be growing (which could present valuation problems that will be discussed later).

3. Net Trade Cycle

An analysis of the company's trade cycle can indicate if the company is having trouble collecting on accounts receivable or if it is having trouble paying its creditors in a timely manner. By looking at the company's days in inventory, the valuation analyst can determine how many times inventory is turning per year, which can also provide some insight into sales performance compared to prior years.

4. Interest-Bearing Debt

It is important to take note of a company's current and long-term debt levels, as the company's debt will factor significantly into the valuation of the company's Fair Market Value of equity.

5. Non-operating Assets

Much like interest-bearing debt, any assets that are held by the company that are not related to the company's operations need to be accounted for by the valuation analyst, as the value of these assets may have a significant impact on the company's equity value.

For M&A transaction purposes, the balance sheet does not provide much insight into how much a company may be worth, with the exception of the amount of interest-bearing debt that a company maintains. A potential buyer will likely be far more concerned with the profitability and growth prospects for a company rather than the condition of that company's balance sheet.

B. INCOME STATEMENT ANALYSIS

There are several items on the income statement that should to be analyzed in order to adequately perform a valuation analysis. Reported net income is not necessarily a quality metric by which to judge a company's performance, although net income may be the first aspect of a company that a buyer will examine when contemplating a potential purchase. In addition to net income, buyers will often look at EBITDA to measure of a company's performance. EBITDA multiples are commonly used by buyers as valuation multiples to determine reasonable purchase prices for target acquisitions. Key income statement items and trends to take note of are as follows:

1. Net Sales

At first glance, an increase in sales over time is a positive indicator on company performance and may indicate a company is gaining market share or penetrating deeper within its current customer base. Increasing sales, however, coupled with a high percentage of variable operating costs, does not necessarily mean the company will realize more profit as sales continue to grow.

2. Gross Margin

A steady or increasing gross profit margin is also a good primary indicator of healthy performance. Growing sales coupled with increasing margins over time could suggest the company is able to effectively manage its costs and may also indicate that the company has been able to adapt to any changes in industry cost structures effectively.

3. Operating Income

A company's operating income is perhaps best expressed as a percentage of net sales. An increasing trend in operating income suggests a company may be experiencing improved efficiencies and that some component of the company's operating expenses are fixed in nature. Companies that operate in such a manner generally experience higher margins as sales increase.

4. Interest Income/Expense

Among those income and expense items classified as “other income/expense” items, it is important to note interest income and expense, as these values will ultimately have an impact on the equity value of the company. Also, it may be important to note items other income/expense items that appear to be non-recurring or do not seem to grow or shrink in a similar pattern to sales, as these items may represent non-operating income or expenses that do not directly relate to the company’s operations.

5. Net Income

Assuming no adjustments need to be made, net income provides insight into the company’s actual earnings. A trend in net income during the historical period analyzed reflects the cumulative effects of changes in gross margins, operating income, and other income or expenses.

C. ADJUSTMENTS TO HISTORICAL FINANCIAL STATEMENTS

Once an analyst has examined the balance sheet and income statement, it may be necessary to make adjustments to reflect a normalized performance. The primary goal of adjusting financial statements is to present the company’s cash flow and EBITDA excluding extraordinary and non-operating items that may skew performance. As was mentioned earlier, a company’s EBITDA is very important in M&A transactions, as debt-free earnings may be a more useful indicator of financial health to a potential buyer than net income, and EBITDA multiples are often used by buyers as a primary check for reasonableness of a selling company’s asking price and by sellers as a reasonableness check against a buyer’s offer price. Adjustments to historical performance generally fall into one of three categories:

1. Non-operating Adjustments

These adjustments are made to adjust for any non-operating assets and related income that the company may experience from ventures outside the scope of business operations. For example, a company may place some of their cash in investments in marketable securities. This asset should be adjusted out of the equity value of the company, and any interest or dividend income associated with the investments that appears on the income statement should be removed from the company’s normalized income.

2. Non-recurring Adjustments

The effects of any income or expense that was extraordinary or non-recurring in nature such as legal fees relating to a lawsuit or the gain or loss associated with the sale of assets should be adjusted out of normalized income. These items represent irregular events that do not accurately reflect sustainable business operations.

3. Control Adjustments

Any expense that can be changed by a controlling-interest shareholder to improve the company's efficiency and profit is subject to a control adjustment. For example, if a controlling-interest shareholder pays him/herself twice the industry average in compensation, then it would be appropriate to adjust owners' compensation expense downward to reflect market rates. By adjusting income to reflect controlling-interest cash flows, a valuation analyst must acknowledge the use of such cash flows in the application of any income approach methods used in the valuation of the company and take appropriate discounts as warranted.

D. RATIO ANALYSIS

After an analysis of the balance sheet and income statement has been performed and any necessary adjustments have been made, it may be useful to look at several key ratios to gain a better perspective of the company's performance. Common ratios to be analyzed can include liquidity ratios such as the current ratio (current assets / current liabilities) and the net working capital to sales ratios; profitability ratios, which include return on assets and return on equity; leverage and coverage ratios, which include the debt capitalization ratio, assets to equity ratio, and times interest earned; and any other ratios that the valuation analyst deems necessary to adequately assess a company's historical performance.

III. VALUATION METHODS – INCOME AND MARKET APPROACHES

Once a valuation analyst has arrived at a normalized stream of earnings for the company, it is necessary to determine which valuation approaches will be appropriate for application to the company. Current valuation theory includes consideration of three commonly accepted approaches to value: a market approach, an income approach, and an asset approach. Each approach contains various valuation methodologies. The choice of which approaches and methodologies to utilize depends on the specific facts and circumstances of the valuation.

A. INCOME APPROACH—DISCOUNTED CASH FLOW METHOD

The income approach is a valuation technique in which the value of a company is estimated based on the earning capacity of that company. The income approach consists of two basic income-driven methods to derive an estimate of Fair Market Value: single period capitalization and multiple period discounting. Single period capitalization is most appropriate when a company's current level of operations is believed to be representative of future operations, and the company is expected to grow at a relatively stable and modest rate. Otherwise, multiple period discounting is more appropriate because it allows for changes to a business' growth rates and profit margins.

For the purposes of an M&A valuation, a multiple period discount model may be most appropriate, as potential investors in a company may be concerned with specific growth prospects in the future years for an acquisition target. As such, the remainder of our income approach discussion will be focused on the Discounted Cash Flow "DCF" method.

1. Projections

The first step in building a DCF model is to obtain company-prepared projections of future performance, or build projections for the company based on industry trends and discussions with company management regarding factors that will affect the company's cash flows in the future.

Sales are the basis for many DCF projections, with a potentially significant amount of the remainder of the model being built off of these figures. As such, obtaining an accurate sales projection is crucial to the accuracy of the overall model. As will be the case with many of the projected items, projecting growth rates may be easier and more accurate than projecting an actual dollar amount. Historical sales growth and discussions with management can help mold an accurate forecast of future sales levels. Gross profit and operating expenses are often forecast in terms of percentage of sales, although operating expenses can be effectively forecast at specific growth rates to capture the fixed and variable nature of these expenses.

After operating income has been forecast, the next step in building a DCF model is to project the company's capital budget. The valuation analyst should take note of historical capital expenditures and depreciation levels and discuss with management any possible large, extraordinary capital expenditures that may be necessary in the future. In the terminal year of the projection period, an adjustment to depreciation should be made (if necessary) such that capital expenditures will exceed depreciation by the long-term growth rate, reflecting growth into perpetuity. This is to ensure there will always be fixed assets to depreciate in the future.

Net working capital is the last element of the projections, and can be forecast either as a percentage of sales, or to grow at a rate based on sales, whichever is deemed to be more appropriate by the valuation analyst. Net working capital should be projected net of cash, non-operating assets, or interest-bearing debt, as these items are accounted for in the calculation of equity value.

Once the projections are complete, the valuation analyst must choose a residual growth rate to grow cash flows at in the future. The residual growth rate should represent only inflationary, economic, and industry growth on a long-term basis. Growth at these levels into perpetuity prevents the inaccurate assumption that the company will perpetually gain market share.

2. Weighted Average Cost of Capital (WACC)

To determine a discount rate applicable to the calculated cash flows, it is necessary to calculate a weighted average cost of capital (“WACC”). The WACC is comprised of two parts, a cost of equity and a cost of debt. The formula to calculate the WACC is as follows:

$$\text{WACC} = K_d \times (D/(D+E)) + K_e \times (E/(D+E))$$

Where:

K_d	=	After Tax Cost of Debt
K_e	=	Cost of Equity
D	=	Book Value of Debt
E	=	Market Value of Equity

$$K_d = \text{Pre-Tax Cost of Debt} \times (1 - \text{Tax Rate})$$

$$K_e = R_f + \beta \times R_m$$

Where:

R_f	=	Risk-Free Rate (long-term Treasury bond)
β	=	Target Beta
R_m	=	Market Risk Premium

After computing the WACC using the formulas above, it is necessary to calculate the present value of the cash flows calculated for each of the projection periods and the residual period to arrive at the company’s enterprise value.

Enterprise value represents the value of a company’s debt and equity. For M&A valuation purposes, it will most likely be required that a valuation analyst conclude at a company’s equity value. Adding the value of cash and non-operating assets and subtracting interest-bearing debt, the effects of which were removed from historical and projected income, provides a calculated equity value.

3. Sensitivity Analysis

Often in M&A valuations, a buyer or seller will want the valuation analyst to provide a range of values that are contingent upon different assumptions. Changing the discount rate (WACC) or the long-term growth rate of a company can greatly affect the value of a company. A sensitivity analysis can be a useful tool for a potential buyer that is curious as to the potential value of a selling company at different levels of growth or different capital structures.

B. MARKET APPROACH

In addition to the DCF and other income approach methods, there are several forms of the market approach that can be used to calculate the value of a company. Market approach methods involve using multiples taken from similar companies or transactions in the subject

company's industry, and applying those multiples to the company's appropriate measure of performance. The market approach takes two primary forms, the Guideline Public Company Method and the Guideline Transaction Method. The criteria for comparability in the selection of publicly traded guideline companies or guideline transactions, as will be discussed later in this section, include business and operational characteristics, growth patterns, relative size, earnings trends, markets served, and risk characteristics.

1. Guideline Public Company Method

The first step in employing the Guideline Public Company Method is to seek and identify potential guideline companies. The initial criteria in selecting a guideline company is that the company is publicly traded, financially solvent, and has a threshold trading price and volume that support that it is not traded at a speculative price. Once these criteria are met, companies in the same or similar line of business as the subject company are considered. Ideally, the selected guideline companies would compete in the same industry as the company being valued; however, exact comparability is not required under this method of valuation. If there are insufficient companies in the same or similar line of business that have securities traded on public markets, it may be necessary to consider companies with an underlying similarity of relevant investment characteristics, such as markets, products, growth, cyclical variability, risks, or other pertinent factors.

Once the companies are selected, the valuation analyst must compare the guideline group to the subject company. There are several areas of comparability that can have an impact on the company's value including, size, growth of sales and earnings, cost structure, and capital structure. After a comparison between the guideline groups and the subject company is made, the valuation analyst needs to determine the multiples that will be applied to the subject company's performance. Possible valuation multiples take into consideration the public companies' market value of equity ("MVE"), enterprise values, and current stock prices, and include the following:

- a) Market Value of Equity ("MVE") to Earnings
- b) MVE to Gross Cash Flow
- c) Enterprise Value to EBIT
- d) Enterprise value to EBITDA
- e) MVE to Book Value of Equity

Applying the appropriate concluded multiples to the subject company's performance will provide a group of enterprise values, equity values, or some combination of the two. The valuation analyst must then convert each calculated equity value to an enterprise value by adding the company's net debt (interest-bearing debt less cash and non-operating assets). The analyst can then choose an enterprise value based on the multiples used or present the range of values calculated from the multiples. Once a calculated enterprise value or range of values has been selected, this enterprise value needs to be converted to equity value. Equity value can be calculated by starting with enterprise value and adding cash and non-operating assets, and subtracting the value of interest-bearing debt.

2. Guideline Transaction Method

Much like the guideline public company method, the guideline transaction method uses publicly available information to calculate the value of a subject company. Unlike the guideline public company method however, the guideline transaction method uses transactions involving the acquisition of private companies, rather than stock prices of publicly traded companies, in an effort to calculate value.

The first step in employing the Guideline Transaction Method is to seek and identify potential guideline transactions. Ideal guideline transactions would involve companies that compete in the same industry as the company being valued; however, exact comparability is not required under this method of valuation. In order for a transaction to be utilized, there must be sufficient publicly available data relating to the transaction to provide evidence of value and the transaction must involve the acquisition of a company within a set of given range of SIC codes.

After a group of transaction is selected, the process is similar to that of the guideline public company method. There are several pricing relationships that can be analyzed, including the following:

- a) Deal Price to Sales
- b) Deal Price to EBITDA
- c) Deal Price to EBIT
- d) Deal Price to Gross Cash Flow

The subject company must be compared to the guideline transactions in terms of size and profitability, and multiples that are appropriate given this analysis must be selected by the valuation analyst. Based on these selected multiples and the subject company's appropriate levels of performance, the valuation analyst will be provided with a range of calculated enterprise values. To convert to an equity value, the analyst must add cash and non-operating assets, and subtract interest-bearing debt, just as was done in the two prior methods. The analyst can then choose to leave the calculation of value as a range or choose a single calculated equity value to present.

3. Choosing the Correct Valuation Methods

For the purpose of an M&A transaction, an analyst representing a selling business will want to emphasize the company's strengths by choosing the appropriate valuation approaches. For example, if a company has been underperforming due to poor management or other factors that can be easily changed under new ownership, the analyst may want to provide a discounted cash flow analysis to present to buyers the company's future growth and profitability potential if being operated efficiently. Conversely, if the company has a stable earnings stream, but potential buyers may be apprehensive about a lack of growth potential, an analyst can present a case using either of the market approach methods demonstrating the multiples that similar companies are trading at in public and private markets to justify the company's value to the buyer.

IV. VALUATION CONCLUSIONS AND POST-ENGAGEMENT USES

A. RECONCILIATION OF VALUATION METHODS USED

Once a value has been calculated for each method used, the valuation analyst can choose a range of values to present or reconcile the conclusions with a single calculation of value. It should be noted that it may not be possible for each method to be used for every company. Some industries are very specialized, with few public competitors or reported transactions. It may also be possible that a company may not be able to provide useful projections or projections may not be possible to build based on the current situation of the company (i.e. if the company has recently made significant changes and there hasn't been enough time to observe the effects of these changes). Even if all of the methods are used, one method may warrant primary consideration over other methods for various reasons. If the analyst was able to find some comparable public companies, but the business descriptions do not match entirely, then it may be appropriate to use that method as a sanity check or a reasonableness check of the other methods used in the calculation of value.

After reconciling to a single value or range of calculated values, the analyst must determine if any discounts need to be applied to the subject interest. For M&A purposes, most valuations will be performed on a marketable, controlling-interest basis, as these transactions usually involve the buying and selling of 100% interests in companies, as investors are unlikely to acquire a minority stake in a company.

B. AUDIENCE AND USES

Potential users of the calculation report include a firm's sell-side clients and potential acquirers of the subject company. An M&A firm can earn a seller's business by providing a clear, concise, logical calculation of value that the seller finds to be an accurate representation of the company's worth. The firm can then provide evidence for an asking price if questioned by potential buyers. A logical presentation of expected future performance in a discounted cash flow model can attract potential buyers that may view the subject company as a profitable business opportunity with a plan for future growth.

C. PRICING

As was mentioned before, pricing for a calculation report can often vary depending on the audience and objective of the report. For a firm competing for a selling company's business, the calculation report may be compiled free of charge in hopes that the presentation of the report will bolster the firm's chances of being engaged by the company to complete the transaction and possibly enjoy a success fee upon the sale of the company. In other instances a firm may decide to charge a flat fee or an hourly consulting rate to compile this type of report.

The most important thing to note in regards to valuation for M&A is that the end product, or the calculation report, is not an opinion of value, but rather a calculation of value that is intended to be used solely for transaction purposes.

Business Valuation for Mergers and Acquisitions

Case Study

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Section I. Company Overview

ABC Homebuilders, Inc.

Company Background

ABC Homebuilders, Inc. (“ABC” or the “Company”) is a residential homebuilder headquartered in Louisville, Kentucky. The Company was founded in 1989 by John Smith. Since its founding, the Company has been responsible for the development of over 15 residential communities including over 700 homes in Louisville and the surrounding areas.

Employees

The Company currently employs 23 individuals, roughly half of which work as full time office staff at the Company’s office. The remaining employee base is comprised of project superintendents, who oversee the development of ABC’s communities, and a few Company employed carpenters. The majority of the work performed by ABC is completed by contractors, who are hired by ABC and directed by the Company’s project superintendents.

Property, Plant, and Equipment

The Company is headquartered at 110 Industrial Parkway in Louisville, Kentucky. Unlike many homebuilders, ABC owns very little construction equipment, as the Company contracts most of its work to outside companies. As such, capital expenditures have been minimal in recent years.

Section I. Company Overview

Company Ownership

ABC currently has five shareholders, including the Company's founder, John Smith, his wife, Jane Smith, and their three children. John Smith currently acts as President and Chief Executive Officer of ABC. John's wife, Mary, does not actively participate in the day-to-day operations of the business. The couple's three children are the remaining shareholders, each holding a position at the Company. Ownership percentages and employment details are as follows:

Company Shareholders		
Shareholder	Position	Ownership Interest
John Smith	President and CEO	51.0%
Jane Smith	-	19.0%
Christopher Smith	Vice President	10.0%
Justin Smith	Project Superintendent	10.0%
Mary Smith	Controller	10.0%

Section II. Industry Overview

Trends in the Residential Construction Industry:

Consolidation. National firms continue to grow through acquisitions, the easiest way to enter new markets. Large homebuilders enjoy economies of scale, with national purchasing power on materials and greater access to capital. Small homebuilders generally don't grow beyond the 30 home annual building level because of the intensely local nature of real estate.

High-Tech Homes. Some large builders have branched into the related fields of modular and manufactured housing, construction materials, commercial construction, mortgages, and insurance. Some builders have established mortgage banking arms to provide financing for home buyers; typically, these operations originate mortgages then sell them to other investors.

Energy Efficiency Growing. Although a "green" home can cost 5% more than a conventional house, some lenders offer mortgage incentives for energy-efficient homes. "Green" building innovations include more porous materials in walkways and patios to prevent erosion from rain runoff, engineered recycled lumber in building, and converting wood or drywall construction waste onsite to landscape mulch.

Reverse Auction. Contractors are concerned over a growing trend among owners to use the Internet to seek the lowest price from anonymous bidders for construction services, a process called "reverse auction." Contractors fighting for the lowest price often sacrifice quality, safety, and margins.

Section II. Industry Overview

Opportunities in the Residential Construction Industry:

Remodeling Market - According to the National Association of Home Builders (NAHB), the remodeling market, which grew nearly 50% from 1991 to 2001, continues to grow. This segment is almost entirely in the hands of small builders. Although individual projects are smaller, the volume of such construction is much steadier than new home construction, and much less financially risky.

Internet Marketing - The Internet can dramatically improve traffic to builder sales centers, increase conversion rates, and improve customer satisfaction by enabling builders to stay connected with customers through the entire home ownership cycle. With Internet technology, potential buyers can visit a number of different developments, view the types of models available, and take virtual tours through model homes. The sites also enable buyers to apply for mortgages and insurance.

Special-Purpose Housing Developments - The changing demographics of the US population suggest that demand for second homes and retirement communities will increase. The large baby boom generation is now in its peak years of earning power and asset accumulation. The long appreciation of the stock market has given many families the means to buy second homes for vacation use, and these same families will be in the age range for retirement during the next decade.

Options, Upgrades - Consumers are demanding more options and upgrades in new homes, a trend that increases the bottom line for builders, whose average gross margin on options and upgrades is about 33 percent, compared to standard housing margins in the low 20 percent range, according to Lennar.

Section III. Historical Balance Sheet

	As Of					% of Total Assets
	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006	
Assets						
Current Assets						
Cash	\$ 595,076	\$ 1,462,293	\$ 490,413	\$ 670,389	\$ 529,476	6.2%
Accounts Receivable	398,330	1,057,704	531,007	419,721	492,483	5.8%
Note Receivable - Shareholder	7,152	7,945	9,621	11,703	13,989	0.2%
Construction in Process - Houses	4,630,712	3,866,496	5,444,459	5,144,576	3,718,652	43.9%
Construction in Process - Models	1,913,486	1,143,006	1,484,796	917,315	1,115,938	13.2%
Lot Inventory	1,062,684	849,052	1,483,888	1,870,666	1,678,247	19.8%
Prepaid Expenses	55,081	43,503	123,468	171,220	131,582	1.6%
Prepaid Lot Deposits	121,500	153,500	78,890	82,500	75,500	0.9%
Prepaid Mortgage Commitments	50,323	23,699	39,447	41,757	8,998	0.1%
Prepaid Other	17,578	39,556	40,242	13,734	16,672	0.2%
Prepaid Construction Loan Fees	12,358	5,431	6,323	6,539	4,952	0.1%
Prepaid Warranty	13,579	-	-	-	-	0.0%
Prepaid Expenses on Lots	-	6,686	57,342	41,453	26,550	0.3%
Total Current Assets	<u>8,877,859</u>	<u>8,658,871</u>	<u>9,789,896</u>	<u>9,391,573</u>	<u>7,813,039</u>	<u>92.2%</u>
Property and Equipment						
Construction Equipment	4,870	9,287	9,864	9,864	9,248	0.1%
Furniture and Fixtures	348,478	309,804	264,035	256,533	259,260	3.1%
Automobiles and Trucks	26,504	26,504	26,504	26,504	26,504	0.3%
Leasehold Improvements	-	-	-	21,945	22,356	0.3%
Mobile Telephones	4,126	1,034	1,034	634	634	0.0%
EDP Software	24,457	20,920	20,920	8,906	8,906	0.1%
Gross Property and Equipment	<u>408,435</u>	<u>367,549</u>	<u>322,357</u>	<u>324,386</u>	<u>326,908</u>	<u>3.9%</u>
Less: Accumulated Depreciation	<u>(218,889)</u>	<u>(219,582)</u>	<u>(219,402)</u>	<u>(199,585)</u>	<u>(204,543)</u>	<u>-2.4%</u>
Net Property and Equipment	<u>189,546</u>	<u>147,967</u>	<u>102,955</u>	<u>124,801</u>	<u>122,365</u>	<u>1.4%</u>
Other Assets						
Architectural Fees - Net	39,173	32,290	20,212	19,485	13,741	0.2%
Passthrough LLC Investments	461,888	627,262	439,203	401,760	527,507	6.2%
Refundable Deposits	1,015	1,015	1,015	1,015	1,015	0.0%
Total Other Assets	<u>502,076</u>	<u>660,567</u>	<u>460,430</u>	<u>422,260</u>	<u>542,263</u>	<u>6.4%</u>
Total Assets	<u>\$ 9,569,481</u>	<u>\$ 9,467,405</u>	<u>\$ 10,353,281</u>	<u>\$ 9,938,634</u>	<u>\$ 8,477,667</u>	<u>100.0%</u>

Section III. Historical Balance Sheet

	As Of					% of Total L & E
	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006	
Liabilities & Shareholders' Equity						
Current Liabilities						
Notes Payable - Bank ST	\$ 4,654,679	\$ 2,527,497	\$ 3,354,431	\$ 2,866,869	\$ 2,387,134	28.2%
Accounts Payable - Trade	1,193,053	1,072,656	866,146	734,004	503,180	5.9%
Customer Deposits	174,610	106,250	197,920	205,920	56,700	0.7%
Accrued Employee Bonus	135,212	203,815	134,423	100,374	69,142	0.8%
Accrued Construction Cost and Repairs	706,661	835,355	628,020	694,396	511,125	6.0%
Accrued Worker's Compensation	-	4,827	-	-	-	0.0%
Accrued Expenses - Other	1	415	309	2,834	5,373	0.1%
Accrued Pension Expense	138,000	134,890	90,120	-	-	0.0%
Subcontractor Retainage	16,648	52,632	67,703	58,017	58,220	0.7%
Current Portion of LT Debt	209,266	-	1,657,873	1,685,941	1,295,941	15.3%
Total Current Liabilities	<u>7,228,130</u>	<u>4,938,337</u>	<u>6,996,945</u>	<u>6,348,355</u>	<u>4,886,815</u>	<u>57.6%</u>
Long-Term Liabilities						
Notes Payable - Sky	209,266	916,248	1,657,873	1,685,941	1,295,941	15.3%
Notes Payable - Shareholders	150,302	136,709	-	-	-	0.0%
Less: Current Portion	<u>(209,266)</u>	<u>-</u>	<u>(1,657,873)</u>	<u>(1,685,941)</u>	<u>(1,295,941)</u>	<u>-15.3%</u>
Total Long-Term Liabilities	<u>150,302</u>	<u>1,052,957</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>0.0%</u>
Total Liabilities	7,378,432	5,991,294	6,996,945	6,348,355	4,886,815	57.6%
Shareholders' Equity						
Common Stock	7,500	7,500	7,500	7,500	7,500	0.1%
Additional Paid In Capital	192,500	192,500	192,500	192,500	192,500	2.3%
Retained Earnings	1,991,049	3,276,111	3,156,336	3,390,279	3,390,852	40.0%
Total Shareholders' Equity	<u>2,191,049</u>	<u>3,476,111</u>	<u>3,356,336</u>	<u>3,590,279</u>	<u>3,590,852</u>	<u>42.4%</u>
Total Liabilities & Shareholders' Equity	<u>\$ 9,569,481</u>	<u>\$ 9,467,405</u>	<u>\$ 10,353,281</u>	<u>\$ 9,938,634</u>	<u>\$ 8,477,667</u>	<u>100.0%</u>

Section IV. Historical Income Statement

	For the Fiscal Year Ended				
	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006
Sales					
Houses	\$ 14,881,822	\$ 18,856,617	\$ 14,637,449	\$ 14,685,680	\$ 12,019,061
Lots	5,043,034	6,768,875	5,143,485	5,219,159	3,807,588
Financing - Estimated	1,615,787	1,715,848	1,507,170	1,372,205	1,218,534
Total Sales	21,540,643	27,341,340	21,288,104	21,277,044	17,045,183
Cost of Goods Sold					
Cost of Sales - Houses	11,547,041	14,844,816	11,669,920	11,931,916	9,578,443
Cost of Sales - Lots	3,885,743	5,194,392	3,986,456	3,966,758	3,047,168
Financing - Actual	1,484,916	1,623,331	1,420,198	1,292,034	1,173,446
Completion Costs - Excess Reserves	(233,633)	(168,850)	(170,186)	(186,501)	(192,932)
Total Cost of Goods Sold	16,684,067	21,493,689	16,906,388	17,004,207	13,606,125
Gross Profit	4,856,576	5,847,651	4,381,716	4,272,837	3,439,058
Operating Expenses					
Construction Expenses	650,766	785,388	731,970	638,218	484,735
Service Expenses	239,140	256,229	208,235	186,447	180,504
Selling Expenses	1,449,908	1,761,859	1,578,540	1,843,165	1,294,311
Administrative Expenses	1,234,938	1,330,303	1,159,998	1,074,203	980,342
Total Operating Expenses	3,574,752	4,133,779	3,678,743	3,742,033	2,939,892
Income from Operations	1,281,824	1,713,872	702,973	530,804	499,166
Other Income (Expense)					
Interest Income	2,697	2,110	5,827	9,169	10,449
Visa Charge Fee	(3,740)	(2,645)	(2,600)	(3,008)	(1,797)
Interest Expense	(209,492)	(218,263)	(195,671)	(330,176)	(364,710)
Loan Processing Fees	(3,675)	(6,000)	(8,665)	(6,250)	(3,800)
Marketing Income - Title First	800	19,000	7,500	8,200	3,000
Partnership Income	156,904	10,400	9,600	346,585	131,953
Miscellaneous Income	33,375	323,220	192,365	31,890	46,209
Income Land Management Fee	-	12,972	17,454	5,000	3,000
Gain (Loss) on Sale of Assets	-	-	2,483	-	1,393
Total Other Income (Expense)	(23,131)	140,794	28,293	61,410	(174,303)
Net Income	\$ 1,258,693	\$ 1,854,666	\$ 731,266	\$ 592,214	\$ 324,863

Section V. Historical EBITDA Calculations

Unadjusted:

	For the Fiscal Year Ended				
	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006
Reported Earnings Before Income Taxes	\$ 1,258,693	\$ 1,854,666	\$ 731,266	\$ 592,214	\$ 324,863
less: Income Taxes @ 40%	(503,477)	(741,866)	(292,506)	(236,886)	(129,945)
Unadjusted Net Income	755,216	1,112,800	438,760	355,328	194,918
plus: Depreciation and Amortization	50,981	48,869	31,034	56,671	48,388
Unadjusted Gross Cash Flow	806,197	1,161,669	469,794	411,999	243,306
plus: Income Taxes	503,477	741,866	292,506	236,886	129,945
less: Interest Income	(2,697)	(2,110)	(5,827)	(9,169)	(10,449)
plus: Interest Expense	3,740	2,645	2,600	3,008	1,797
Undjusted EBITDA	\$ 1,310,717	\$ 1,904,070	\$ 759,073	\$ 642,724	\$ 364,599

Adjusted:

	For the Fiscal Year Ended				
	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006
Reported Earnings Before Income Taxes	\$ 1,258,693	\$ 1,854,666	\$ 731,266	\$ 592,214	\$ 324,863
Normalization Adjustments					
Loss (Gain) of Sale of Assets	-	-	(2,483)	-	(1,393)
Excess Owner's Compensation	100,000	100,000	100,000	100,000	100,000
Total Normalization Adjustments	100,000	100,000	97,517	100,000	98,607
Adjusted Earnings Before Income Taxes	1,358,693	1,954,666	828,783	692,214	423,470
less: Income Taxes @ 40%	(543,477)	(781,866)	(331,513)	(276,886)	(169,388)
Adjusted Net Income	815,216	1,172,800	497,270	415,328	254,082
plus: Depreciation and Amortization	50,981	48,869	31,034	56,671	48,388
Adjusted Gross Cash Flow	866,197	1,221,669	528,304	471,999	302,470
plus: Income Taxes	543,477	781,866	331,513	276,886	169,388
less: Interest Income	(2,697)	(2,110)	(5,827)	(9,169)	(10,449)
plus: Interest Expense	3,740	2,645	2,600	3,008	1,797
Adjusted EBITDA	1,410,717	2,004,070	856,590	742,724	463,206

Section VI. Historical Valuation Analysis

Unadjusted:

	For the Fiscal Year Ended				
	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006
Unadjusted Net Income	755,216	1,112,800	438,760	355,328	194,918
plus: Depreciation and Amortization	50,981	48,869	31,034	56,671	48,388
Unadjusted Gross Cash Flow	806,197	1,161,669	469,794	411,999	243,306
plus: Income Taxes	503,477	741,866	292,506	236,886	129,945
less: Interest Income	(2,697)	(2,110)	(5,827)	(9,169)	(10,449)
plus: Interest Expense	3,740	2,645	2,600	3,008	1,797
Unadjusted EBITDA	1,310,717	1,904,070	759,073	642,724	364,599
Unadjusted EBITDA Multiples					
4 x EBITDA	5,242,868	7,616,280	3,036,292	2,570,896	1,458,396
5 x EBITDA	6,553,585	9,520,350	3,795,365	3,213,620	1,822,995
6 x EBITDA	7,864,302	11,424,420	4,554,438	3,856,344	2,187,594
7 x EBITDA	9,175,019	13,328,490	5,313,511	4,499,068	2,552,193

Adjusted:

	For the Fiscal Year Ended				
	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006
Adjusted Net Income	\$ 815,216	\$ 1,172,800	\$ 497,270	\$ 415,328	\$ 254,082
plus: Depreciation and Amortization	50,981	48,869	31,034	56,671	48,388
Adjusted Gross Cash Flow	866,197	1,221,669	528,304	471,999	302,470
plus: Income Taxes	543,477	781,866	331,513	276,886	169,388
less: Interest Income	(2,697)	(2,110)	(5,827)	(9,169)	(10,449)
plus: Interest Expense	3,740	2,645	2,600	3,008	1,797
Adjusted EBITDA	1,410,717	2,004,070	856,590	742,724	463,206
Adjusted EBITDA Multiples					
4 x EBITDA	5,642,868	8,016,280	3,426,360	2,970,896	1,852,824
5 x EBITDA	7,053,585	10,020,350	4,282,950	3,713,620	2,316,030
6 x EBITDA	8,464,302	12,024,420	5,139,540	4,456,344	2,779,236
7 x EBITDA	9,875,019	14,028,490	5,996,130	5,199,068	3,242,442

Section VII. Discounted Cash Flow Analysis

Projection Assumptions:

	For the Year Ended		For the Year Ending				
	12/31/2005	12/31/2006	Year 1 12/31/2007	Year 2 12/31/2008	Year 3 12/31/2009	Year 4 12/31/2010	Year 5 12/31/2011
Total Sales	\$ 21,277,044	\$ 17,045,183	\$ 17,557,000	\$ 18,084,000	\$ 18,627,000	\$ 19,186,000	\$ 19,762,000
% Growth Rate	n/a	-19.9%	3.0%	3.0%	3.0%	3.0%	3.0%
Gross Profit	4,272,837	3,439,058	3,547,000	3,653,000	3,763,000	3,876,000	3,992,000
% Gross Margin	20.1%	20.2%	20.2%	20.2%	20.2%	20.2%	20.2%
Operating Expenses	3,742,033	2,939,892	3,019,804	3,110,448	3,203,844	3,299,992	3,399,064
% Operating Expenses / Total Sales	17.6%	17.2%	17.2%	17.2%	17.2%	17.2%	17.2%
% Growth Rate	n/a	-21.4%	2.7%	3.0%	3.0%	3.0%	3.0%
Other Income	385,425	180,362	175,570	180,840	186,270	191,860	197,620
% Other Income / Total Sales	1.8%	1.1%	1.0%	1.0%	1.0%	1.0%	1.0%
Capital Budget							
Net Capital Expenditures	67,788	36,807	38,000	39,000	40,000	41,000	43,000
% CAPEX / Total Sales	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Depreciation and Amortization	56,671	48,388	38,000	39,000	40,000	41,000	41,710
% Depreciation / Total Sales	0.3%	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%
Net Working Capital	6,925,639	6,079,823	6,262,382	6,450,357	6,644,039	6,843,428	7,048,881
% Growth	n/a	-12.2%	3.0%	3.0%	3.0%	3.0%	3.0%
% Net Working Capital / Total Sales	32.5%	35.7%	35.7%	35.7%	35.7%	35.7%	35.7%

* Net Working Capital is defined as (Current Assets- Cash) – (Current Liabilities – Interest Bearing Debt)

Section VII. Discounted Cash Flow Analysis

Weighted Average Cost of Capital (WACC)

Cost of Equity and Required Return on Debt

Cost of Equity			Required Return on Debt	
Risk Free Rate of Return		4.56%	3-Month LIBOR	4.70%
Market / Equity Risk Premium	6.00%		Plus: Prime Spread Over LIBOR	2.75%
Selected Equity Beta	<u>1.00</u>	6.00%	Plus: Credit Risk Premium	<u>0.50%</u>
Small Stock Risk Premium		6.27%	Floating Rate, Pretax Cost of Debt	7.95%
Subject Company (Unsystematic) Risk Premium		<u>4.00%</u>	Plus: Cost to Swap to a Fixed Rate	<u>0.48%</u>
			Fixed Rate, Pretax Cost of Debt	8.43%
			Less: Income Tax Factor of 40%	<u>-3.37%</u>
Cost of Equity		<u>20.83%</u>	Required Return on Debt	<u>5.06%</u>

Calculation of the WACC

$WACC = K_D \times (D/(D+E)) + K_E \times (E/(D+E))$ <p>Where: K_D = After Tax Required Return on Debt K_E = Cost of Equity D = Book Value of Debt E = Market Value of Equity</p>	Percentage of Capital Structure Comprised of Equity	60.00%
	Cost of Equity	20.83%
	Percentage of Capital Structure Comprised of Debt	40.00%
	Cost of Debt	5.06%
	Weighted Average Cost of Capital	14.52%
	Rounded	14.50%

Section VII. Discounted Cash Flow Analysis

Calculation of Value – Enterprise Value

	For the Year Ending				
	Year 1 12/31/2007	Year 2 12/31/2008	Year 3 12/31/2009	Year 4 12/31/2010	Year 5 12/31/2011
Total Sales	\$ 17,557,000	\$ 18,084,000	\$ 18,627,000	\$ 19,186,000	\$ 19,762,000
Cost of Goods Sold	14,010,000	14,431,000	14,864,000	15,310,000	15,770,000
Gross Profit	3,547,000	3,653,000	3,763,000	3,876,000	3,992,000
Operating Expenses	3,019,804	3,110,448	3,203,844	3,299,992	3,399,064
Income from Operations	527,196	542,552	559,156	576,008	592,936
Other Income	175,570	180,840	186,270	191,860	197,620
Earnings Before Income Taxes	702,766	723,392	745,426	767,868	790,556
Income Taxes @ 40%	281,106	289,357	298,170	307,147	316,222
Debt-Free Net Income	421,660	434,035	447,256	460,721	474,334
Adjustments:					
Plus: Depreciation and Amortization	38,000	39,000	40,000	41,000	41,710
Less: Capital Expenditures	(38,000)	(39,000)	(40,000)	(41,000)	(43,000)
Less: Additional Working Capital	(182,559)	(187,975)	(193,682)	(199,389)	(205,453)
Distributable Cash Flow	239,100	246,060	253,574	261,332	267,591
Present Value Factor @ 14.5%	0.9345	0.8162	0.7128	0.6226	0.5437
Present Value of Distributable Cash Flow	\$ 223,448	\$ 200,832	\$ 180,755	\$ 162,695	\$ 145,495
Present Value of Cash Flows (Years 1 to 5)	\$ 913,225				
Present Value of Residual Cash Flow	1,303,127				
Enterprise Value	2,216,352				
Rounded	\$ 2,200,000				
				Year 5 Cash Flow	\$ 267,591
				Multiplied by: One Plus Growth Rate	1.03
				Residual Cash Flow	275,619
				Discount Rate	14.5%
				Less: Residual Growth Rate	-3.0%
				Capitalization Rate	11.5%
				Residual Cash Flow Value	2,396,687
				Present Value Factor	0.5437
				Present Value of Residual Cash Flow	\$ 1,303,127

Section VIII. Sensitivity Analysis

Effects of Changes in WACC and Long-Term Growth Rate on Enterprise Value

<u>Growth</u>	<u>WACC</u>				
	<u>13.5%</u>	<u>14.0%</u>	<u>14.5%</u>	<u>15.0%</u>	<u>15.5%</u>
1.0%	\$ 2,100,000	\$ 2,000,000	\$ 2,000,000	\$ 2,000,000	\$ 1,900,000
2.0%	2,200,000	2,200,000	2,100,000	2,100,000	2,000,000
3.0%	2,300,000	2,300,000	2,200,000	2,200,000	2,100,000
4.0%	2,500,000	2,400,000	2,400,000	2,300,000	2,200,000
5.0%	2,700,000	2,600,000	2,500,000	2,400,000	2,400,000

Δ in Enterprise Value relative to value calculated using WACC of 14.5% and Long-Term Growth Rate of 3.0%

<u>Growth</u>	<u>WACC</u>				
	<u>13.5%</u>	<u>14.0%</u>	<u>14.5%</u>	<u>15.0%</u>	<u>15.5%</u>
1.0%	-4.5%	-9.1%	-9.1%	-9.1%	-13.6%
2.0%	0.0%	0.0%	-4.5%	-4.5%	-9.1%
3.0%	4.5%	4.5%	-	0.0%	-4.5%
4.0%	13.6%	9.1%	9.1%	4.5%	0.0%
5.0%	22.7%	18.2%	13.6%	9.1%	9.1%

Section IX. Industry Analysis

Selected Comparable Transactions Recently Disclosed Merger & Acquisition Activity

	Acquired Company	State	Year	SIC	Deal Price	Sales	EBITDA	EBIT
1	Parker & Lancaster Corporation	VA	2000	1521	\$ 6,234,000	\$ 92,006,010	\$ 2,066,592	\$ 1,917,926
2	Hammonds Homes, Ltd.	TX	2002	1521	82,800,000	180,253,556	18,387,550	17,372,670
3	Landmark Homes, Inc.	NC	1996	1521	5,000,000	19,640,000	815,000	747,000
4	Don Galloway Homes, Inc.	NC	1997	1521	34,600,000	57,123,396	5,431,219	5,398,004
5	n/a	GA	2001	1521	450,000	1,620,000	176,000	176,000
6	n/a	NC	2005	1521	825,000	1,011,593	99,582	99,582
7	Design Company, Inc.	MA	2005	1521	3,257,000	9,440,100	482,100	395,500
8	Realen Homes, L.P.	n/a	2004	1521	58,348,000	128,680,000	n/a	6,198,000
9	n/a	TX	2006	1521	775,000	4,200,000	n/a	133,000
10	D. W. Hutson Construction Company	FL	1997	1521	18,700,000	79,571,000	7,888,000	7,775,000
11	n/a	MN	2004	1521	175,000	671,772	7,934	7,934
12	n/a	WI	1997	1521	248,920	1,038,829	362,864	68,007
13	Monarch Homes, Inc.	MN	2004	1521	5,000,000	22,913,341	976,943	925,788
14	Trafalgar House Property, Inc.	DC	1998	1521	90,000,000	166,551,000	n/a	5,991,000
15	California Homebuilding Operations of The Forecast Group,	CA	2002	1521	264,500,000	507,233,000	n/a	72,105,000
16	Diamond Key Homes, Inc.	AZ	1998	6552	11,100,000	54,103,833	1,344,496	1,248,792
	High				\$ 264,500,000	\$ 507,233,000	\$ 18,387,550	\$ 72,105,000
	Upper Quartile				40,537,000	101,174,508	2,907,749	6,042,750
	Median				5,617,000	38,508,587	895,972	1,087,290
	Lower Quartile				812,500	3,555,000	316,148	165,250
	Low				6,234,000	92,006,010	2,066,592	1,917,926

* data gathered using *Pratt's Stats*, display of "n/a" indicates data was not provided

Section IX. Industry Analysis

Selected Comparable Transactions

Transaction Multiples applicable to Enterprise Value

Acquired Company	EBITDA Margin	Deal Price / Sales	Deal Price / EBITDA	Deal Price/ EBIT
1 Parker & Lancaster Corporation	2.2%	0.07	3.02	3.25
2 Hammonds Homes, Ltd.	10.2%	0.46	4.50	4.77
3 Landmark Homes, Inc.	4.1%	0.25	6.13	6.69
4 Don Galloway Homes, Inc.	9.5%	0.61	6.37	6.41
5 n/a	10.9%	0.28	2.56	2.56
6 n/a	9.8%	0.82	8.28	8.28
7 Design Company, Inc.	5.1%	0.35	6.76	8.24
8 Realen Homes, L.P.	n/a	0.45	n/a	9.41
9 n/a	n/a	0.18	n/a	5.83
10 D. W. Hutson Construction Company	9.9%	0.24	2.37	2.41
11 n/a	1.2%	0.26	22.06	22.06
12 n/a	34.9%	0.24	0.69	3.66
13 Monarch Homes, Inc.	4.3%	0.22	5.12	5.40
14 Trafalgar House Property, Inc.	n/a	0.54	n/a	15.02
15 California Homebuilding Operations of The Forecast Group, L.P.	n/a	0.52	n/a	3.67
16 Diamond Key Homes, Inc.	2.5%	0.21	8.26	8.89
High	34.9%	0.82	22.06	22.06
Upper Quartile	10.0%	0.47	7.13	8.44
Median	7.3%	0.27	5.63	6.12
Lower Quartile	3.7%	0.23	2.90	3.67
Lower Quartile	2.2%	0.07	3.02	3.25

* data gathered using *Pratt's Stats*, display of "n/a" indicates data was not provided

