CHAPTER 2

Creating and Measuring the Value of Private Firms

Owners of private firms manage their businesses to increase their after-tax profit. Unfortunately, this may not always translate to maximizing the value of their firms. In this chapter, we introduce a framework that more closely ties the desire to increase after-tax profits to maximizing the value of the firm. We call this framework the *managing for value model* (MVM). While models of this sort are often used to quantify whether business strategies undertaken by public firms create value for shareholders, it is also a powerful tool for evaluating whether the business decisions of control owners result in increasing their private wealth. When applying the model, owners immediately realize actions taken that might increase revenue and even increase after-tax profit may not lead to an increase in firm value, and in some cases actually result in a decrement in value. They, of course, wonder how this is possible. It is, to say the least, counterintuitive, but nevertheless, it is an outcome that often emerges. The question is: What are the circumstances that give rise to this result? The answer varies, but in general it emerges when a particular business strategy yields an after-tax rate of return that, while positive and large, is nevertheless not large enough. This means that the after-tax rate of return is lower than the financial costs to create it, resulting in a decrement in firm value.

To see this, assume a firm borrows $100 at 10 percent and promises to pay back the loan at the end of one year. The firm invests the $100 and only earns 8 percent, so at the end of the year the investment is worth $108. However, the firm promised to pay the lender $110 at the end of the year. Where does the firm get the additional $2? Simple, either the firm sells off some assets, issues some stock, or borrows the $2 from another financial source. In any case, the owner is $2 poorer and the firm is worth $2 less. Thus, earning a positive return does not necessarily mean that the firm and the owner are better off. Indeed, using earnings as a measure of success may lead management to take actions that destroy, rather than enhance, the value of the firm. Employing the MVM reduces the likelihood that this will happen.

The MVM sets down procedures that help business owners and managers understand the options available to create competitive advantage and maximize the value of the firms they both own and manage. Owners create value by managing current firm assets, adding new assets, and altering how both current and future assets are financed. Determining how to deploy the firm's current and future assets is the domain of business strategy. How the asset base is financed is the domain of financial policy. This discussion gives rise to the first principle of managing for value:

> Principle 1. *Owners maximize the value of what they own when a firm's financial policies are properly aligned with the firm's business strategies. This occurs when the value of expected after-tax cash flows from a firm's assets is maximized and the firm's after-tax financing costs are minimized.*

In the section that follows, the basic components of the MVM are discussed and analyzed. In Chapter 3 the MVM is applied to a real-world case involving Richard Fox, the CEO and a significant owner of Frier Manufacturing.

THE MVM

The MVM is summarized in Figure 2.1. As one moves counterclockwise around the outer circle, the degree of strategic management intensifies. Less active strategic management implies that owner/managers are optimizing the cash flows from the assets in place at the optimal capital structure. Optimal capital structure is the debt-to-equity ratio that yields a maximum value for the cash flows from assets in place. When management becomes more active, it adds assets and continues to finance them at the optimal capital structure. When net fixed capital and sales grow at their historical rates, management is undertaking an active strategy designed to exploit market opportunities that have been previously identified. Examples include pricing initiatives intended to increase market share or sales increases of previously introduced new products. The value that emerges from implementing these actions is known as *going-concern value,* and it reflects the continuation of past business decisions into the future.

Highly active strategic management begins when the firm's owners decide to alter the basis of competition in some significant way. Such changes might include a business restructuring designed to reduce costs, lower prices, and increase market share in each of the markets served, developing new products and services, and/or entering new markets. Each of these changes represents a significant change in a firm's strategy, and each

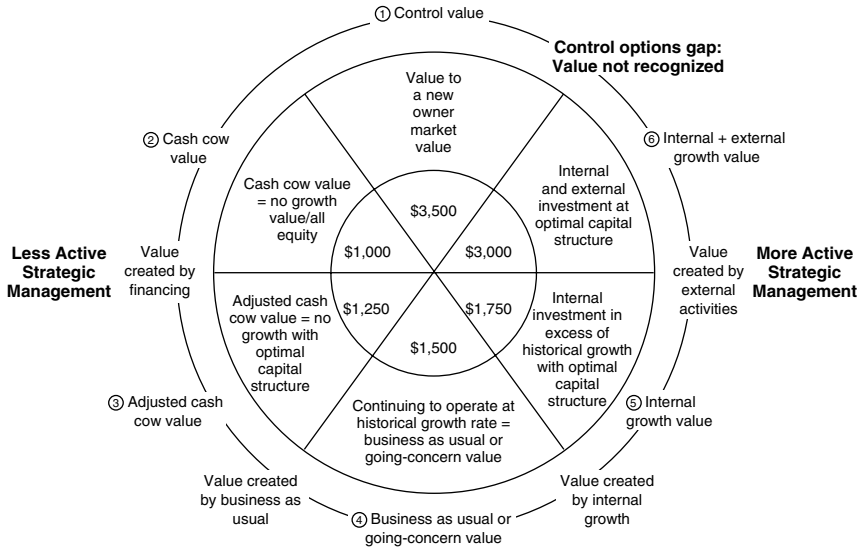


FIGURE 2.1 The Value Circle Framework

usually requires the firm to increase internal investments or net new capital expenditures beyond what it has historically done. Depending on the strategic thrust, management may decide that buying is cheaper than building and therefore decide to commit itself to an acquisition or series of acquisitions. Such external investments might be accompanied by divestitures of business units that no longer fit with the firm's core business strategy.

MEASURING THE CONTRIBUTION OF STRATEGY TO FIRM VALUE

Figure 2.1 shows that a firm's value is the sum of the values created by various strategic initiatives. The aggregation of these values is equal to the value of the firm, which is also equal to the sum of the market value of the firm's equity plus the market value of its debt. Moving counterclockwise, the no-growth value is made up of the value of assets in place. This value is equivalent to capitalizing the firm's current cash flow by its equity cost of capital. In this case, each year's gross investment equals annual depreciation, so the assets in place are always sufficiently maintained to provide the required cash flow. Thus, if a firm's annual after-tax cash flow is $1 million and the firm's cost of equity capital is 10 percent, then the firm has an equity market value of $10.0 million ($1 million ÷ 0.10). If the firm has 1 million

shares outstanding, then each share is worth $10. This can be thought of as its *cash cow value* since the firm would be generating cash that would not be reinvested but would be distributed to owners.[1]

By altering the firm's capital structure, the cash cow value can potentially be enhanced. Keep in mind that total firm value is equal to the market value of equity plus the market value of debt. Interest costs are tax deductible and dividends from equity shares are not. Therefore, if a firm can issue $1 of debt and buy back a $1 of equity, thus refinancing the asset base, its tax bill will be reduced. This reduction will occur each year over the life of the debt, and thus the present value of these tax savings is the value increment associated with this refinancing. These tax benefits come at a cost, however. As the firm increases its leverage, the probability of bankruptcy also increases. As long as the present value of additional debt adds more value through its tax benefit than the value decrement that occurs because of the increased probability of bankruptcy, then adding debt will increase firm value. The optimal capital structure will emerge when these two offsetting factors are equal.[2] The firm's optimal capital structure, its optimal debt-to-equity ratio, is located at the minimum (maximum) point of the firm's cost of capital (value) curve, as shown in Figure 2.2.

The extension of the optimal capital structure concept to S corporations was indirectly offered by Merton Miller in his 1976 presidential address to the American Finance Society. In this address he showed how leverage affects firm value in the presence of both corporate and personnel taxes. The Miller model shows that even if a firm does not pay an entity-level tax, like an S corporation, leverage can still create value.

It is often thought that a private firm cannot alter its capital structure cost effectively and easily. This view is not correct. In addition to commercial banks, there are other sources of lending to private firms, including private investor groups such as small business investment companies (SBICs), which are sponsored by the SBA to provide debt as well as equity financing. The sources of financing have been growing rapidly over the past 15 years, reflecting the growth in the number and value of private firms. The basic factors determining the ability of a private firm to refinance have not changed, however. The greater the transparency of a firm's operations and the more sustainable the firm's cash flow, the greater the chances that a refinancing strategy at competitive rates of interest can be achieved.

Determining the optimal capital structure is a complicated exercise and beyond the scope of this chapter. For the moment, let us assume that management has determined that the optimal capital structure is 50 percent debt and 50 percent equity and, as a result, the adjusted cash cow value is $1,250 million. This adjusted value less the cash cow value of $1,000 million, represents the value created through financial restructuring.

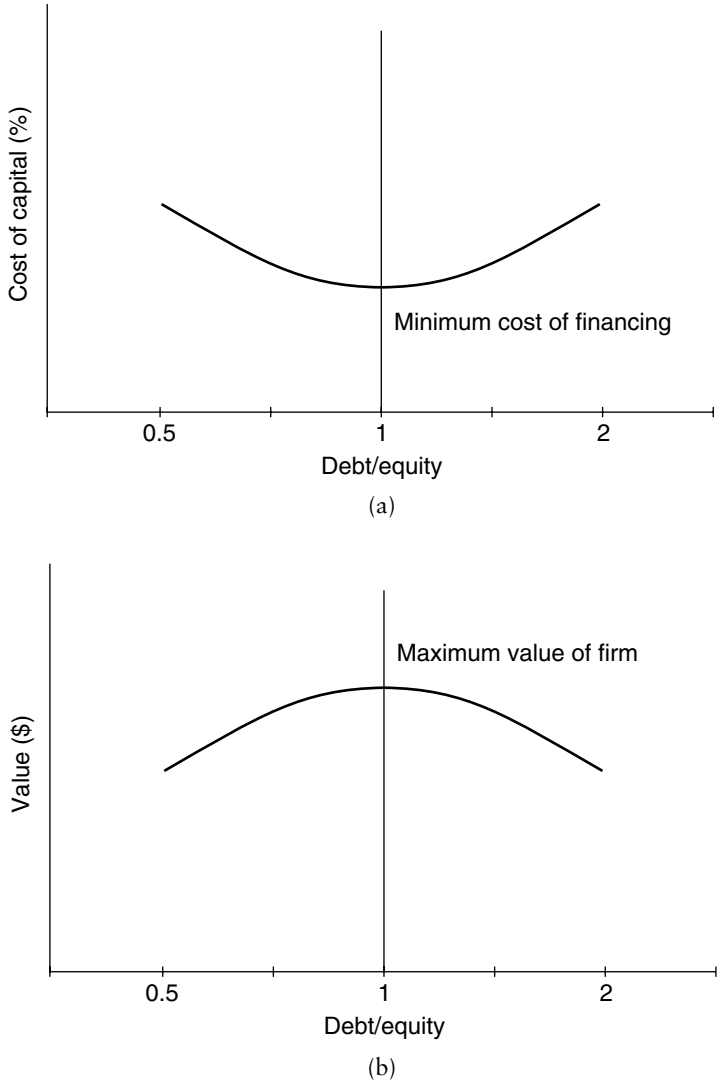


FIGURE 2.2 Value Curve

The business-as-usual value, or *going-concern value,* is a product of the firm's sales and capital needs growing at recent historical rates. These activities are financed at the firm's optimal capital structure and reflect the fact that management does not expect the future to deviate in any important way from the past. Say management plans to increase capital expenditures

in excess of depreciation to take advantage of identified growth opportunities. These new investments are expected to create additional value for the firm. Going-concern value is calculated to be $1,500 million, with the difference between it and the adjusted cash cow value, $1,250 million, representing the additional value created by the net increase in capital expenditures.

There are several reasons why the going-concern value exceeds the adjusted cash cow value. The first is that the going-concern value reflects strategic opportunities, and therefore the net new investment is expected to yield a rate of return in excess of the firm's cost of capital, which by definition does not occur in an adjusted cash cow environment. This implies that the value of the incremental after-tax cash flows exceeds the value of the net new investment required to generate them. This emerges either because the incremental after-tax cash flows are sufficiently large and/or the increments created last for a sufficiently long enough time to validate the investment made. The period over which a firm is expected to earn rates of return that exceed its cost of capital is known as the *competitive advantage* period. Because competition has become more intense across all industries, it is difficult to sustain what economists call *monopoly rents* for an extended period. This insight leads to the second principle of managing for value:

> Principle 2. *All else equal, the greater the degree of competition in any served market, the shorter the length of the competitive advantage period the firm faces and the less likely that any strategic initiative will create firm value.*

As principle 2 becomes operative and its effects visible, the greater the likelihood that owners of private firms begin to entertain and host strategic initiatives designed to defend, and potentially alter, the basis of competition in served markets. In addition, owners may consider developing new products and services and/or enter new markets where the firm can more effectively create barriers to entry, thereby increasing the length of the competitive advantage period.

When it becomes apparent to owners that they must alter the way they do business in order to sustain their current position, they begin to explore the implications of this new reality in terms of internal and external investment options and to select those that enhance the firm's competitive position and create a more valuable firm. Internal options include developing new product lines, investing in research and development (R&D), initiating programs to cut overhead and variable costs, opening new markets for existing products, and increasing market share in served markets for existing products and services. When the value of these additional activities is

added to going-concern value, the value of the firm, or its internal growth value, rises to $1,750 million.

Keep in mind that the internal growth value can be lower than the going-concern value. This occurs when the present value of costs of internal investments exceeds the present value of the cash flows produced by these investments. We gave a simple example of this phenomenon at the beginning of this chapter. We now want to formalize it as an operating principle and give an example of it at work.

> Principle 3. *A firm should undertake a net new investment only when the expected rate of return exceeds the cost of capital required to finance it. This will occur when the present value of expected cash flows exceeds the present value of net new investments.*

How an investment strategy can destroy value is exemplified by the 1980s experience of oil company executives who blindly committed large sums of capital to finance oil exploration and development when it was clear that such investments destroyed firm value. While this example concerns itself with public firms, many private firms were involved in oil exploration as well during this time. They, like their public firm counterparts, believed that the high price of a barrel of oil was, in itself, sufficient to undertake the large expenditure that oil exploration required. As it turns out, principle 3 was violated, and this led to a restructuring of the oil industry and to a major restructuring across other industries as well. This occurred because it became clear that many firms had been violating principle 3, which in turn offered opportunities to entrepreneurs to purchase these firms, divest operations that were not adding value, and thus create a more valuable entity. Put differently, entrepreneurs purchased firms for less than they were worth and, by suspending operations that were not creating value, were able to create a more valuable entity.

When Strategy Destroys Value: The Case of the Oil Industry

In the early 1980s, the corporate value of integrated oil firms was less than the market value of their oil reserves, their primary assets. The question arose, how could such a mispricing occur given that the major oil companies are so widely followed by the investor community? A 1985 research report prepared by Bernard Picchi of Salomon Brothers provided the answer. The report indicated that the 30 largest oil firms earned less than their cost of capital of about 10 percent on their oil exploration and development expenditures.[3]

Estimates of the average ratio of the present value of future net cash flows of discoveries, extensions, and enhanced recovery to expenditures for exploration and development for the industry ranged from less than 0.6 to slightly more than 0.9, depending on the method used and the year. In other words, on average, the oil industry was receiving somewhere between 60 and 90 cents for each dollar invested. The corporate value of these firms reflected the sum of the market value of oil reserves minus the value destroyed by investing in oil exploration and development. Therefore, by undertaking internal investments that destroyed value, stock prices of these oil firms were lower than they would have been had they immediately terminated most of their exploration and development activities. The strategic implications of this analysis are that it was cheaper to obtain oil reserves through buying the assets of a competitor than it was to invest internally and explore. In this way, the capital markets provided incentives for firms to make strategic adjustments that were not stimulated by competitive forces in the international markets for oil. In the end, shareholder wealth increased significantly as some oil firms merged and others restructured. The events that transpired and the shareholder wealth gains that materialized are described in the following article.

RESTRUCTURING OF THE OIL INDUSTRY

Gains to the shareholders in the Gulf/Chevron, Getty/Texaco, and DuPont/Conoco mergers, for example, totaled more than $17 billion. Much more is possible. In a 1986 MIT working paper, "The 217 Agency Costs of Corporate Control: The Petroleum Industry," Jacobs estimates total potential gains of approximately $200 billion from eliminating the inefficiencies in 98 petroleum firms as of December 1984.

Recent events indicate that actual takeover is not necessary to induce the required adjustments:

The Phillips restructuring plan, brought about by the threat of takeover, involved substantial retrenchment and return of resources to shareholders, and the result was a gain of $1.2 billion (20 percent) in Phillips's market value. The company repurchased 53 percent of its stock for $4.5 billion in debt, raised its dividend 25 percent, cut capital spending, and initiated a program to sell $2 billion of assets.

Unocal's defense in the Mesa tender offer battle resulted in a $2.2 billion (35 percent) gain to shareholders from retrenchment and return of resources to shareholders. Unocal paid out 52 percent of its equity by repurchasing stock with a $4.2 billion debt issue and reduced costs and capital expenditures.

The voluntary restructuring announced by ARCO resulted in a $3.2 billion (30 percent) gain in market value. ARCO's restructuring involved a 35 to 40 percent cut in exploration and development expenditures, repurchase of 25 percent of its stock for $4 billion, a 33 percent increase in its dividend, withdrawal from gasoline marketing and refining east of the Mississippi, and a 13 percent reduction in its workforce.

The announcement of the Diamond-Shamrock reorganization in July 1985 provides an interesting contrast to the others because the company's market value fell 2 percent on the announcement day. Because the plan results in an effective increase in exploration and capital expenditures and a reduction in cash payouts to investors, the restructuring does not increase the value of the firm. The plan involved reducing cash dividends by 76 cents per share (a cut of 43 percent), creating a master limited partnership to hold properties accounting for 35 percent of its North American oil and gas production, paying an annual dividend of 90 cents per share in partnership shares, repurchasing 6 percent of its shares for $200 million, selling 12 percent of its master limited partnership to the public, and *increasing* its expenditures on oil and gas exploration by $100 million per year.

External Strategies: Acquisitions

The oil industry case suggests that external investment strategies should always be seriously considered. External strategies include acquisitions and various types of divestitures of nonstrategic assets. In general, an acquisition should be considered when there are synergies between the acquirer and the target firm. In this case, the value of the combined firms should exceed the sum of the market values of each as stand-alone businesses. This difference is termed *acquisition* or *synergy value*. If the price paid for a firm exceeds its current market price, the difference being termed the *target premium,* then the net value created by the acquisition is the difference between the synergy value and the target premium. The value of the combined firms is then equal to the value of each firm as a stand-alone plus the difference between the acquisition value and the target premium. Keep in mind that a target's value not only reflects the additional cash flows that are expected to emerge as a result of the combination, but any options that the combination may create to be exercised in the future if circumstances develop that support such execution. Because such strategic options are difficult to quantify, they are often overlooked when valuing an acquisition. This, of course, would be a mistake, since it necessarily leads to undervaluing any acquisition undertaken.

The value created by an acquisition can be seen by considering the case of Firm A, which has a current stand-alone market value of $100, and Firm T, which has a current stand-alone value of $50. Firm A believes that it can manage Firm T's assets and create additional value of $25. This $25 is the synergy value. If Firm A paid a $10 premium for Firm T's assets (i.e., paid $60 for them), the combined value of Firms A and T would equal $115 (stand-alone Firm A value of $100 + stand-alone Firm T value of $50 + $25 synergy value – $60 Firm T cost = $115). Firm A is willing to pay a premium for Firm T's assets because Firm A can create additional value that exceeds the target premium by being able to control how Firm T's assets are to be deployed. Hence, the target premium is also known as the *control premium.* This acquisition creates $15 of value for the owners of Firm A because they paid $60 for something that is worth $75. Keep in mind that the $25 in value that Firm A's owners believe can be created may reflect incremental direct cash flows that emerge from the combination—removal of redundant administrative costs, for example, as well as options to do things in the future that would not be possible or financially feasible without control of Firm T's assets. These options might include Firm T patents not in use and R&D programs. Keep in mind that these options are not part of the additional cash flows expected to emerge because of the combination, but represent cash flows that emerge only if the patents not in use, for example, are exercised at some future time. This leads to principle 4:

> Principle 4. *An acquisition should not be undertaken if the price paid exceeds the incremental value that the acquisition is designed to create. Any incremental value should reflect both the direct expected cash flows and any options embedded in the assets being acquired.*

Acquisition strategies are often thought to be the sole domain of public firms. This is not only untrue, but private firms often have more to gain by pursuing acquisition strategies than do their public firm counterparts. The reason relates to the influence of firm size on value, as attested by the following case study.

CASE STUDY: FPI Restructures to Create Value

Joel owns FPI, a financial planning organization. FPI was recently valued at $36 million, or three times its past 12 months of revenue of $12 million. The financial planning industry is fragmented and is made up of a large number of smaller producers. John has approached Joel and is willing to help him finance a series of acquisitions. The idea is to purchase a series of smaller firms for about three times their annual revenue, integrate the firms, and sell the larger entity to a financial services firm that is willing to pay a multiple well in excess

of 3 for the integrated firm. John has studied recent acquisitions in other industries and has noticed larger firms sell for much larger multiples of revenue than smaller firms.

This observation leads John to initiate a strategy that leverages Joel's operating experience and an investor's willingness to pay a premium for larger firms. John convinces Joel that purchasing two firms with annual revenue of $12 million each and integrating them with Joel's firm will create a combined entity that is worth more than it costs to create. Total revenue of the combined entity is $36 million, and at three times revenue, its value is $108 million. John and Joel know that Financial Services Inc. (FSI) has been looking to acquire a financial planning firm that is sufficiently large to make an impact on the performance of FSI. John and Joel's new firm provides the size that FSI is looking for, in addition to a wealthy customer base to whom FSI can sell its various products and services. FSI is willing to pay four times revenue for John and Joel's firm, which means they and their 20 minority shareholders increase their wealth by $36 million ($4 \times \$36 - 3 \times \$36$).

Acquisitions in the private market often make sense when an industry is fragmented and made up of a number of small producers. By aggregating these businesses and integrating their operations, the value of this new combined entity has a value that exceeds the sum of the values of the two businesses as stand-alone operations. This occurs even if there are no additional cash flows that result from the combination. The reason is that the combined entity is less risky than the risk of each entity separately. This means that the cost of capital of the combination is lower than the cost of capital of each business as a stand-alone operation.

An example would be helpful. Suppose Firms A and B have after-tax earnings of $100 in perpetuity and each has a cost of capital of 10 percent. The value of each firm is therefore $1,000 ($100 ÷ 0.10). The two firms combined have a value of $2,000, but this is understating the value of the combination, since the new larger firm with an after-tax cash flow of $200 also has a lower cost of capital, 9 percent. This lower cost of capital means that the combination is worth $2,222, or an additional $222 in value simply because of size.[4]

In addition to size, there are at least two other reasons why a larger firm will sell at a higher multiple of revenue than a smaller firm. The first relates to scale. The time and effort it takes to integrate a larger target is often as great as it is for a smaller target. Hence, for the same effort and cost, the benefits are greater for a larger entity than for a smaller entity. Second, the synergy options are often far greater when the purchased entity is larger. More new products and services can be sold through a larger organization than a smaller one, and therefore the after-tax cash flow per employee is likely to be far greater as well. In addition to these factors, if an acquirer is a public firm, it may be able to pay a higher premium than an acquiring private firm for a target's cash flow. The reason is that the public firm has additional purchasing capacity, since it is valued at a premium relative to the

value of a comparable private firm. That is, equity shares of public firms are more liquid than the shares of comparable private firms. This means that public firm shares sell at higher multiples of revenue than the shares of comparable private firms. This increased liquidity emerges because owners of public firms can sell their shares cost-effectively and at prices that fully reflect expectations of informed investors regarding the firm's underlying risk and earnings potential. Therefore, if a public firm can purchase a private firm in the same industry at a revenue multiple of 4 and then have the public market revalue this purchased revenue at 5, the acquisition creates value for the shareholders of the public firm.

The arithmetic is simple and compelling. As indicated in the FPI case, FSI pays $144 million for $36 million of revenue. Once the acquisition is announced, the value of the financial services firm will increase by $36 million, or the difference between $180 million (5 × $36 million) and $144 million. This upward revaluation occurs solely because the public firm is a more liquid entity. This result leads to principle 5:

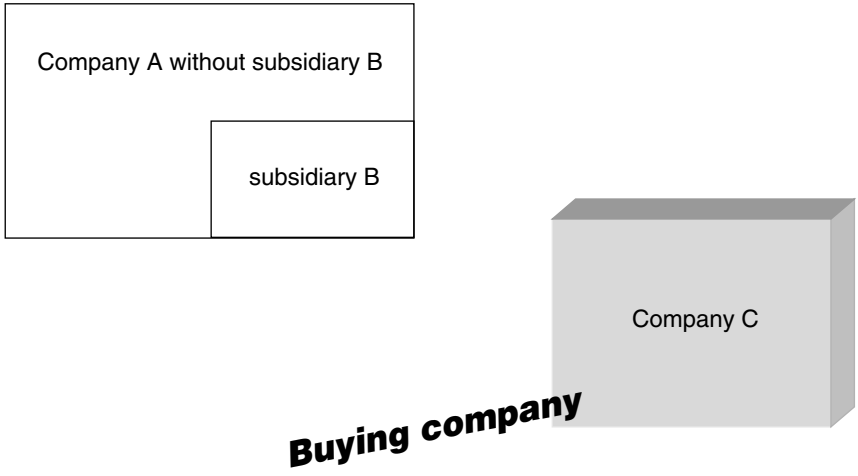
> Principle 5. *Given two firms in the same industry, one public and the other private, the public firm will always pay more for a target than a comparable private firm, all else equal.*

External Strategies: Divestitures

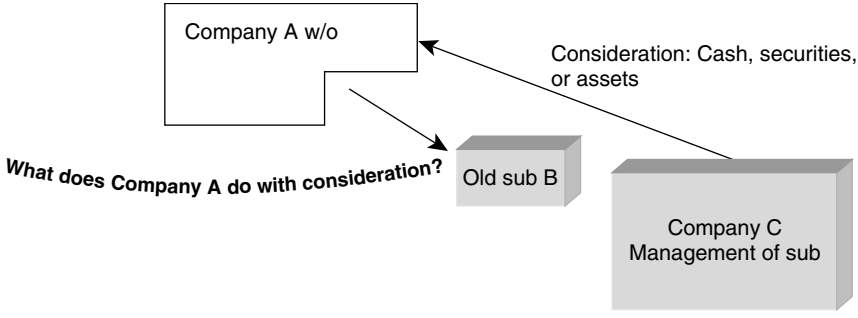
In addition to acquisitions, owners of private firms may decide to sell only part of the business. This type of business restructuring can take several forms: divestitures, equity carve-outs, and spin-offs being the most notable. As shown in Figure 2.3, a divestiture is the sale of a division or a portion of a firm in return for cash and/or marketable securities.

The sale may be to another firm or it may be a management buyout (MBO). When the sale is financed with a significant amount of debt, the transaction is termed a *leveraged buyout* (LBO). If the division's sale price exceeds its value to the parent as a stand-alone business, then the divestiture increases the market value of the selling firm by this difference. To see this, consider Firm A, which is made up of two divisions, each valued at $50. Division 2 is sold for $60, a $10 premium over its intrinsic value. After the sale, Firm A is worth $110 (division 1 = $50 + division 2's sale proceeds = $60), or $10 more than before the sale. This example gives rise to principle 6:

> Principle 6. *If a division or line of business of a private firm is worth more to outsiders (external market) than it is internally, then the entity should be sold and the funds received should be deployed in a business line where the owner and/or the firm has a measurable competitive advantage, thus ensuring that the value of the firm is maximized.*



(a) *Company before Divestiture*



(b) *Company after Divestiture*

FIGURE 2.3 Structure of a Divestiture

VIVENDI REJECTS MGM BID FOR ENTERTAINMENT ASSETS

By John Carreyrou and Martin Peers
Staff Reporters of the *Wall Street Journal*

Vivendi Universal SA rejected Metro-Goldwyn-Mayer Inc.'s $11.5 billion bid for its U.S. film and TV businesses as too low and refused to bow to MGM's demand for more due diligence information, according to people familiar with the matter.

Vivendi's rebuff of MGM's ultimatum comes days after it dismissed Liberty Media Corp.'s demand for exclusive negotiations, signaling the French company's resolve not to be bullied by bidders in the high-profile media auction.

The move also shows Vivendi is being ambitious in the price it is seeking for the assets, which include the Hollywood studio Universal Pictures, the Universal theme parks, a television production studio, and cable TV networks.

Though still saddled with a large debt load of some €13 billion, Vivendi believes it can afford to be picky because it has restructured its debt to be able to last well into 2004 without a cash injection.

The company's confidence also has been buoyed by the recent stock market rally, which it thinks could allow it to proceed with an initial public offering of the businesses should bidders' offers remain underwhelming.

MGM bid $11.2 billion for the businesses in the auction's first round last month, putting it at the upper level of bids received. Other bidders included John Malone's Liberty Media, General Electric Co.'s NBC, Viacom Inc., and an investor group led by former Seagram CEO Edgar Bronfman Jr.

Seeking an edge, MGM earlier this week told Vivendi in a letter that it was prepared to raise its offer to $11.5 billion on the condition that it receive more information about the businesses by next Monday, including details about agreements governing how Vivendi's cable channels are carried by cable and satellite TV systems. While Vivendi wasn't happy with MGM's demands for extra information, which ran to almost 20 pages, one person familiar with the situation said its attitude might have been different if MGM's revised bid had been higher. But Vivendi considers it too low, several people familiar with the matter said.

If the five remaining bidders don't raise their offers significantly, Vivendi is likely to emphasize its willingness to go the IPO route. However, an IPO would take more time. Vivendi doesn't have a chief executive to oversee the businesses, making an IPO tough to market to investors. Hiring a CEO for the entertainment units would certainly delay the operation for several months.

The auction should drag on for several more weeks and isn't likely to be resolved until some time in August, if not later. Vivendi has asked bidders to submit proposed contract terms by the end of this month. In auctions, the contractual terms can be as important as the price offered.

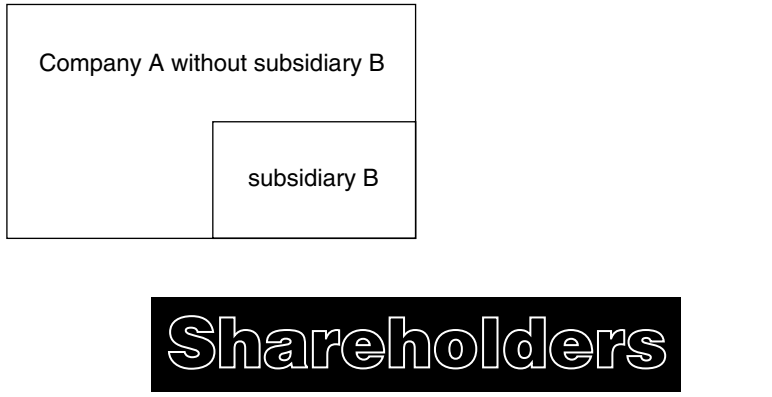
Another divestiture strategy is termed a spin-off. While public firms have employed a spin-off strategy to successfully increase parent firm value, the strategy has not been fully exploited by owners of private firms. As a general rule, spin-off strategies are viable for private firms with multiple stockholders that have at least two *strategic business units* (SBUs), which are defined as self-contained businesses within the larger firm. Typically, an SBU can be split from the parent without creating any substantive operating inefficiencies within the parent. Private firms that fit this description include firms with multiple investor groups, such as professional investment firms and other supraminority investors, who believe their investment is worth more if the divisions can be valued separately.

As shown in Figure 2.4, in a spin-off a parent firm distributes shares on a pro rata basis to its stockholders. These new shares give shareholders ownership rights in a division or part of the company that is sold off. Management hopes that the value of the spun-off division will be assigned a higher value by investors than its implied value as part of the parent firm.

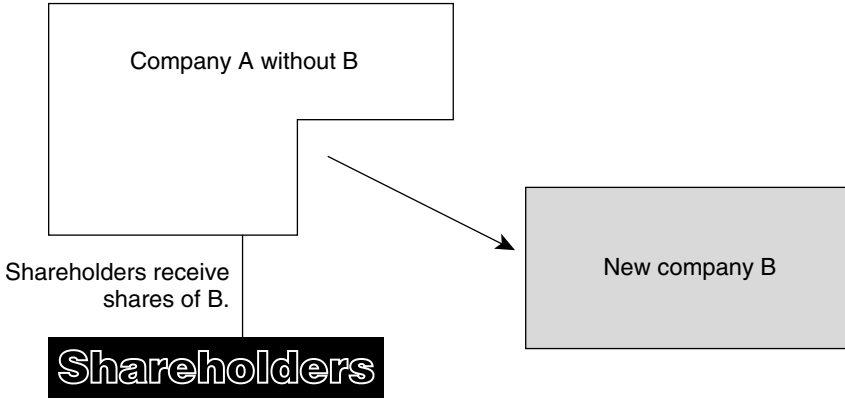
The use of spin-offs rather than divestitures to effectively shed assets became very popular in the 1990s. The primary motivation for this switch was the tax advantages associated with spin-offs that were no longer available if assets were sold for cash. Prior to the repeal of the General Utilities Doctrine in the 1980s, firms could sell assets without any capital gains consequences. After its repeal, spin-offs became an attractive alternative for a parent firm since shareholders received stock, not cash, and thus there were no tax consequences for the selling parent.

Although spin-offs do not produce additional cash for shareholders, they can create additional firm value. When a division is spun off, a new entity is formed with newly issued equity shares. Shareholders now own shares of the parent and shares of the spun unit. To the extent that there are potential buyers for the spun unit that were unwilling to buy the shares of the parent when the spun unit was part of the parent, a spin-off strategy creates additional liquidity for the shareholders. This additional liquidity translates into additional value.

In other cases, separating the division from the parent allows management of the division to take advantage of business opportunities that it could not as part of a larger entity, and in the process create additional value for parent firm shareholders. For example, some years back a large insurance firm spun off its money management division into a wholly owned subsidiary to enhance its competitive position in the investment management marketplace. Prior to the spin-off, all investment decisions had to be sanctioned by the insurance firm's investment policy committee, which caused unnecessary delays. In addition, because it was part of a large bureaucratic organization, customer perception was that the firm was not nimble enough to take advantage of investment opportunities as they emerged. Because of the spin-off, this



(a) *Pre-Spin-Off Company*



(b) *Post-Spin-Off Company*

FIGURE 2.4 Spin-Off

perception quickly changed, and yet the money management subsidiary retained the cachet of being affiliated with a large, financially strong parent. Subsequent to the spin-off, the firm's performance improved relative to peer companies, and the hoped-for increase in customers and cash flow followed.

While spin-offs make sense, the real question is whether they create value. There have been a number of academic studies that indicate that spin-offs

positively impact the value of the firm. Schipper and Smith report that, on average, shareholders receive an extra 2.84 percent return because of spin-offs, and this additional return increases as the spun division is a larger percentage of the parent.[5] In terms of dollar value, the value of the parent increases by the value of spun division. For example, if the value of parent prior to the spin-off is $100, and the value of the spun division is $10, then the post-spin-off value of the parent is $110.

Equity Carve-Outs

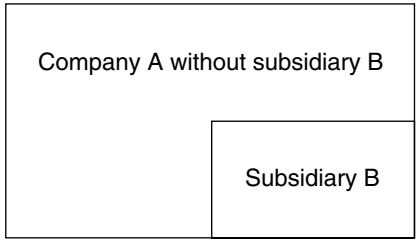
An equity carve-out is the sale of an equity interest in a subsidiary of a firm. A new legal entity is created whose shareholders may not own equity in the firm of the divesting parent. This new entity has its own management team and is run as a separate and distinct business. The parent may not necessarily retain control of the carve-out, but the divesting parent receives a cash payment that typically exceeds the implied equity value when the carve-out was part of the parent. Unlike a spin-off, an equity carve-out produces cash for the parent since it sells a percentage of the equity shares in the new firm to investors and retains the remainder. After the transaction is complete, the shareholders of the parent have reduced their ownership in the carved-out division. In contrast, a spin-off strategy leaves the parent firm shareholders with the same interest in the spun division as they had before the spin-off.

A private firm can easily accomplish an equity carve-out. While divisions of a parent are typically carved out when the parent is a public firm, because of the smaller size of private firms, divisional carve-outs would generally not be practical. However, there is no reason why a particular product line or a segment of a division could not form the basis of an equity carve-out. In this case, the private firm would form a new entity and then sell shares. Figure 2.5 shows how an equity carve-out works.

Like spin-offs, equity carve-outs have been shown to produce substantial incremental returns for investors of the parent firm. Schipper and Smith report that shareholders of parent firms that undertook equity carve-outs posted average incremental returns of 1.8 percent.[6] In short, outright sale of a division, spin-offs, and equity carve-outs are external strategies designed to unleash value that cannot be achieved under the predivestiture business organization. While public firms adopt these strategies to increase share prices, they are also viable options for private firms and offer a means to create a more valuable private entity.

THE CONTROL GAP

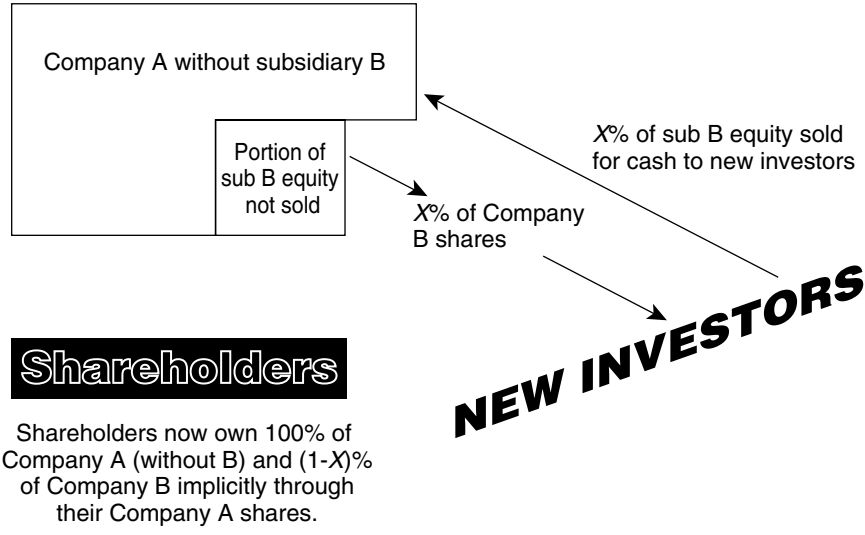
Figure 2.1 shows that in-place internal and external strategies are expected to produce a firm worth $3,000. However, a potential buyer may be willing



Shareholders

Shareholders implicity own 100% of equity of subsidiary B through their Company A shares.

(a) *Company before Carve-Out*



Shareholders

Shareholders now own 100% of Company A (without B) and (1-*X*)% of Company B implicitly through their Company A shares.

(b) *Company after Carve-Out*

FIGURE 2.5 Equity Carve-Out

to pay an additional sum of as much as $500 to control the firm's assets. The control gap emerges when the value of the firm to a buyer exceeds the value to the current ownership. There are two types of control buyers, each having different options but nevertheless willing to pay a premium for the target. The first type we term the *business-as-usual* (BAU) buyer. This buyer adopts the same overall strategy as the seller but brings a more professional management style to the business with the expectation of creating a more efficient operation and generating higher cash flows from the assets in place. A common example of this type of buyer is a former executive of a major public firm, typically a baby boomer, whose career has run its course in a large corporate setting and who desires to be a business owner. This former executive is considering the purchase of a private firm that he believes can benefit from his management skill with the hope of creating greater efficiencies and greater cash flow. This is the basis for his willingness to pay a premium for the business in the first place.

The second type is the strategic purchaser. This buyer believes that by combining assets of the target and the acquiring firm, additional cash flows become available that would not otherwise be possible. The strategic buyer has options, because of the assets it already owns, that the BAU buyer does not. These options potentially enable the strategic buyer to create incremental cash flows that are larger and last longer than those that a BAU buyer can be expected to create. In short, the incremental value that a strategic buyer can create will always exceed that of a BAU buyer. This leads to principle 7:

> Principle 7. *A strategic buyer will always pay more for a target than a BAU buyer because the strategic buyer has more options than the BAU buyer does.*

Although there are other examples of this phenomenon, one need only refer to the FSI case to understand how a control value emerges that is larger than the value of the target with in-place strategies. Here, FPI exercised its external strategy and purchased a number of smaller financial service firms, then turned around and sold the new, larger organization to FSI, which was willing to purchase this business at a control value that exceeded what a BAU buyer would be willing to pay. The difference emerges because FSI is a strategic buyer, with options for the use of FPI's assets that would be available only to it and not to a BAU buyer.

What might these strategic options be? There are many, but one that would certainly be available is a broader array of products and services that FPI, even under a new BAU management team, could not afford to offer. Financial services firms face significant administrative and legal oversight burdens. Despite broker-dealer affiliations that have allowed smaller

financial services firms to reduce administrative overhead, these costs remain significant and are becoming more so given the ever-increasing legal oversight hurdles that these firms face. In short, by integrating operations with a much larger parent, the acquirer can offer both economies of scale and scope to the target that would result in a sizable reduction in the administrative and distribution fixed costs, thereby increasing the target's profit margins well above what would be possible if the target were left to its own devices.

PRIVATE FIRM VALUE AND TRANSPARENCY

In addition to taking advantage of profit growth opportunities, the value of any firm is influenced by the quality of its financial and operational disclosures. Public firms with management that has a policy of timely disclosure of operational and financial information will always have a higher value than identical firms that do not adopt policies that encourage transparency. Transparency reduces investor uncertainty, yielding a reduced cost of capital and a higher firm value. Accurate financial reporting, ethical management behavior, and transparency come under the central rubric of *good governance*. A recent study by GovernanceMetrics indicates that firms that receive high marks on governance issues seem to be rewarded for their good behavior by the stock market, as shown in Figure 2.6.

Based on these results, one would expect that private firms that are well run and are characterized by accurate financial reporting would also be rewarded with higher values for their good behavior. Since equities of private firms do not trade on a market, the daily impact on value from good governance is not seen except on those occasions when the firm's equity needs to be valued. This occurs more frequently than one might think. For example, the positive effect of transparency will ordinarily arise when private firms are for sale and the buyers are carrying out normal due diligence, when a firm is attempting to obtain outside financing from a bank or private equity firm, and/or when a firm is providing critical financial and operational information to joint venture partners and to large public firm customers. Although the value of the firm is not calculated in each of these instances, the effect of meeting high standards of transparency does ultimately translate to higher firm value. Signs of poor record keeping, excessive compensation to family members, evidence of mixing personal and business expenses, sweetheart deals related to rental agreements, loans to owners at below market rates—all raise concern that there may be more skeletons in the closet. While these adjustments usually result in a lower tax bill, either because expenses are artificially high, as seen by mixing personal and business expenses, or because revenues are too low, a typical result of loans to shareholders at below market rates, these benefits quickly become

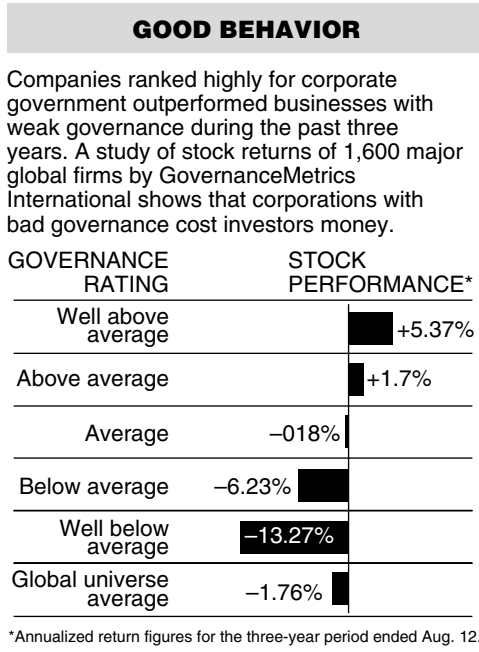


FIGURE 2.6 Good Behavior

burdensome costs when the firm is ready to be sold. The reason is that outsiders will always accord a less transparent firm a higher risk resulting in a higher cost of capital than a firm that is more transparent. This higher cost of capital results in a firm with a lower value. Finally, having customers with a well-known reputation for dealing only with firms that meet and exceed certain credit and other performance standards means that the firm-customer relationship is "sticky," and the cash flow that emanates from it will have a longer duration and therefore be worth more, which of course translates into higher value.

While the vast majority of private firms are small, and issues of transparency typically abound, the larger a private firm is the greater the degree of transparency that is required. The reason is that a private firm's stakeholders—customers, suppliers, joint-venture partners, and creditors—have a need to understand the extent to which management/owner decisions may impact the contracting arrangements the firm has with each of its stakeholders. The information these relationships require should not be confused with the reporting requirements of public firms to accurately disclose. Rather, the type, quantity, and quality of required information arises from the need to properly assess the risks of doing business with private firms.

For example, most public firms that have private firm vendors require that these firms disclose critical financial information to them before they will enter into a vendor relationship, let alone a joint venture. It goes without saying that banks and other credit institutions keep close tabs on their private firm clients, particularly those for whom they have extended long-term debt or have made other substantive financial commitments.

PRIVATE COMPANIES ALSO FEEL PRESSURE TO CLEAN UP ACTS

By Matt Murray
Staff Reporter of the *Wall Street Journal,* July 22, 2003

The Sarbanes-Oxley Act is aimed at making publicly traded companies more accountable. But it's having a big impact on privately owned companies as well. Dick Jackson, chief financial officer of Road & Rail Services Inc., doesn't have to file public reports on his company's operations. The logistics and transportation concern, based in Louisville, Kentucky, has just three owners.

But in recent months, Road & Rail, which has 400 employees and about $25 million in annual sales, has been tweaking its corporate-governance practices. Mr. Jackson has added layers of review to the process of compiling financial results, and boosted accountability by ensuring that different managers are responsible for approving invoices and signing checks. The board is contemplating inviting one or more independent directors aboard.

Why the changes? Mr. Jackson says his company, like others, has been learning from the scandals at Enron Corp., WorldCom Inc., and elsewhere. So have a growing number of its clients—along with its banks and insurance companies—and they want to ensure Road & Rail can back up its books as well as its promises. Many of its clients are public companies that have overhauled their own governance in response to the new regulations, Mr. Jackson says.

"Philosophically, as a privately held company, you don't want everything exposed to the world," he says. "On the other hand, the world is changing, and there's a lot more sharing of information between customers and suppliers and business partners. I think everything eventually is an external event."

Indeed, the Sarbanes-Oxley Act is having a ripple effect "much more far-reaching than any of us knew," Mr. Jackson says.

Among the changes, closely held companies are quietly overhauling their boards and upgrading their accounting standards. In addition to addressing their own concerns, managers are being pressured to make

changes by customers, investors, accountants, and venture capitalists. Many companies also are reacting to the rising cost of insurance for directors and officers.

Just last month, a federal judge in New York City ruled that directors at bankrupt Trace International Holdings Inc. failed in their responsibilities by allowing its chairman and controlling shareholder, Marshall Cogan, to exhaust funds through excessive compensation, dividends, and loans. The decision makes it clear that "private company directors and officers are going to be held to the same standard as public company officers and directors to determine whether or not they are fulfilling their fiduciary duties," says John P. Campo, a partner at LeBoeuf, Lamb, Greene & MacRae LLP, who represents the bankruptcy trustee in that case.

To be sure, most private companies have stopped far short of the measures adopted by their public peers, and executives at many remain tight-lipped about their operations to outsiders and even employees and some investors. After all, avoiding the spotlight and the paperwork that comes with being public is part of the reason that many stay private. "I want the right disciplines in place," says Marilyn Carlson Nelson, chairwoman and chief executive of Carlson Companies Inc. in Minneapolis, a family-controlled company that owns an array of hotel, marketing, and travel industry chains and brands, including T.G.I. Friday's restaurants and Radisson Hotels & Resorts. She adds that she doesn't want employees or investors "worried" about governance at the company, which through its own and franchised operations oversees 198,000 workers and about $20 billion in sales. But at the same time, she says, "We can't become so rigid that we lose the sense of innovation and become totally risk-averse. Our intention is to be transparent in what we do, but our intention is not to make the board into managers and operators of the company." Entrepreneurs are by nature risk takers, she says, adding, "We don't claim to the board or to each other that we're never going to fail or something won't go wrong." Of late, Carlson has been taking a more active role in monitoring external auditors and expanding internal control and disclosure requirements, such as those involving off-balance-sheet commitments, says its chief financial officer, Martyn R. Redgrave. The company's board already had independent directors and an audit committee, he notes.

"The standard I have applied is that if we find the rules relative to current practices would increase transparency or awareness, we are in favor of them," he says. But he adds that some of the new requirements are "form over substance" and says, "We're not going to sweep through our entire global system to do what is required for public companies. We're using it as a new benchmark against which we measure ourselves, and we have a lot of it in place."

Perhaps the companies most affected in the new climate are small, entrepreneurial ventures that need venture-capital funding and have high hopes of one day going public. At Celleration Inc., a tiny medical-technology company in Minneapolis with nine employees and no revenue, Chairman and CEO Kevin Nickels last year structured his six-member board so that four directors were outsiders: two of them investors and two of them industry figures. Neither of the two insiders—Mr. Nickels and company founder and chief technology officer Eliaz Babaev—sits on the audit or compensation committees.

Part of the motivation for such measures is pragmatic. "What you're doing is building the confidence for new investors," says Mr. Nickels. "You're not going to get financed unless money sources trust you."

But he says he also had a strong belief, as a manager, in the importance of independent outsiders on his board. "It's common sense," he says. "Rarely does an individual make it happen. It's usually a team of people, and a team is successful when you bring in all the bright ideas of a broadly experienced and deep group of people."

SUMMARY

This chapter outlined the various factors that determine the value of private firms, and in particular set down a number of operating principles that should guide the owners of private businesses and their advisors when they undertake any strategic initiative. The basic principle is that generating more profit from any activity does not necessarily translate to increased value unless the rate of return earned exceeds the financial cost of undertaking it. In this context, the MVM is an efficient way to ascertain whether the basic business activity an owner is contemplating undertaking makes financial sense.