VALUE & VALUATION:
Are Private Firms Prepared for Mission-Critical Decisions?

A Survey of Senior Financial Executives
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ABSTRACT

Knowing and understanding the value of a firm is fundamental, and for a publicly traded company this is easy to estimate. Yet most firms in the U.S. are private and the shares of more than a few public firms trade infrequently, so this study attempts to measure how many private and closely-held company leaders know their firms' values. A survey of 194 senior financial executives was conducted as part of a webinar entitled, "The Fallacy of Safe Harbors: Managing for Value in the Private Firm". Over half who reported they had at least "some idea" of their firms' values relied on internal estimates whose accuracy is far from assured, while another one-third of executives rely on professional valuations that likely bear little resemblance to enterprise value. We conclude that most senior executives in private companies do not know what their firms are worth and, despite foreign and better-financed competitors, most unrealistically view their firms as potential acquirers (instead of targets) and few expect to raise capital for new growth initiatives. We therefore believe major improvements in management philosophy and practice as they relate to private firm value and valuation are urgently needed.

INTRODUCTION

Knowing and understanding the value of a firm is fundamental, given the fiduciary duty of senior executives and board members to protect and enhance shareholder value. Yet corporate valuation, especially of private firms, is complex in both theory and practice, and rational decisions with perfect information are extremely rare. Nevertheless, mission-critical decisions of both strategic and tactical importance need to be made, and most require knowing a firm's value and the effect the decision will have on its value.

Firms whose shares trade publicly are relatively easy to evaluate, provided there is frequent trading among a large number of investors: the most recent share price multiplied by the number of shares outstanding reveals a precise and accurate – though perhaps fleeting – measure of *shareholder value*. And by adding to this the firm's outstanding debt, one easily arrives at the comprehensive measure of *enterprise value*.

Yet most firms in the U.S. are privately held and the shares of more than a few public firms trade infrequently or are held by few investors, many of whom are insiders, rendering them "closely held" or effectively private. Given this, we wanted to know how many private company executives – particularly financial executives, including the chief financial officer, vice president of finance, treasurer and controller – actually know their firm's value, and if so how.

METHODOLOGY

A survey of 194 senior financial executives was conducted by Waterford Advisors LLC, its affiliate, Numeria Management LLC, and the Institute of Management Accountants (IMA) as part of a webinar held on January 19, 2006.

The webinar – an hour-long seminar delivered through the World Wide Web – was produced live by the IMA as part of its monthly *Inside Talk* professional education series. It was titled, "The Fallacy of Safe Harbors: Managing for Value in the Private Firm".

When registering for the webinar, the executives were asked four multiple-choice or short-answer questions (the "Registration Questions"). In addition, each provided his or her name, title, firm name, contact information, industry and firm revenue. During the webinar – which was attended by 95 executives[*] – they were also asked two polling questions that reflected the content of the webinar (the "Polling Questions").

[*] The IMA considered the 49% participation rate (95 out of 194 registrants) excellent, as compared to previous *Inside Talk* webinars and given the registrants' ability to view it later at their convenience.

Registration Questions		
1	What is the ownership structure of your firm?	◻ Private, Management Owned ◻ Private, Private Equity Financed ◻ Publicly Traded ◻ Other
2	Do you know the value of your firm?	◻ Yes ◻ No
3	If yes, how do you know its value?	◻ Professional Valuation ◻ Public Stock Price ◻ Management Estimates ◻ Wishful Thinking
4	If no, why not?	Short Answer

Polling Questions		
1	What is your firm's biggest competitive threat?	Short Answer
2	In the next 2 or 3 years, do you envision your firm:	◻ Raising private equity ◻ Selling to a strategic buyer ◻ Going public ◻ Acquiring other firms ◻ Staying the course

The Registration and Polling Questions were asked and answered via computer, with the latter posed during the webinar. Because the executives participated via their personal computers, some may not have been logged-on when all questions were asked, or chose not to answer them. Finally, the data were tabulated by the IMA and conveyed to Waterford and Numeria immediately following the webinar.

We eliminated the responses by nineteen out of the 194 registrants because they were affiliated with universities or not-for-profit organizations, and therefore were not deemed appropriate for a survey about creating and measuring corporate value.

In addition, we chose to simplify the results of the first Registration Question (about firm ownership structure) because of the nineteen eliminated responses and the ambiguous wording of the question (i.e., respondents could have misinterpreted "management owned" vs. "private equity financed", and a firm could in fact be both management owned *and* private equity financed). Therefore, the 175 remaining registrant responses were classified as either *privately held* or *publicly held*.

RESULTS

Registration Question #1: Ownership Structure

Privately Held	152	87%
Publicly Held	23	13%
Total	175	100%

Registration Question #2: Knowing Your Firm's Value (Private Firms Only)

Yes	94	62%
No	58	38%
Total	152	100%

Registration Question #3: If Yes, How Do You Know Its Value? (Private Firms Only)

Professional Valuation	34	36%
Management Estimates	53	56%
Wishful Thinking	7	7%
Total	94	99%*

* Does not equal 100% due to rounding.

Registration Question #4: If No, Why Not? (Private Firms Only)

Left Blank	46	79%
Exceeds my area of responsibility Not interested Firm only two years old Why do you want to know? I am a subsidiary president, not privy to that That info is closely guarded by owners We're privately held with many secrets The firm is not for sale Too many factors and lack of need to know Book value only; no idea of market value I don't know the owner's long term plan I'm new to the firm, getting an appraisal now	12	21%
Total	58	100%

Polling Question #1: What is your firm's major competitive threat?

Global Competition	9	22%
Weak Pricing	6	15%
Innovations	5	12%
Insufficient Capitalization	4	10%
Undifferentiated Products/Saturated Market	4	10%
Interest Rates/Economy	2	5%
Counterfeit Products	1	3%
Regulation	1	3%
Nepotism	1	3%
No Barriers to Entry	1	3%
Internal Bureaucracy	1	3%
Other	5	12%
Total	40	101%*

Polling Questions #2: In the next 2 to 3 years, do you envision your firm…

Raising private equity capital	9	13%
Selling to a strategic buyer	8	12%
Going Public	2	3%
Acquiring other firms	20	29%
Staying the course	29	43%
Total	68	100%

* Does not equal 100% due to rounding.

ANALYSIS

With 87% of the executives associated with a private firm, this survey reasonably reflects the population of U.S. companies and is therefore suitable for exploring the valuation of middle market corporations and its effect on management decisions.

In knowing the value of one's firm, only 62% of the private firm executives surveyed said they did. And of those, a significant portion – 6 out of every 10 – relied on management estimates or wishful thinking; the balance relied on a professional valuation. This is noteworthy in several respects.

First, over one-half (56%) said they relied on estimates, either their own or by others on the management team, meaning that the analysis was neither objective nor independent, which are considered essential elements when valuing a firm. Whether or not their valuation methods were appropriate and their conclusions accurate cannot be known from this data, but our experience suggests that very few senior financial executives have valuation expertise. Therefore, in this segment valuation accuracy is far from assured.

Over half of executives who had "some idea" of their firm's value relied on internal estimates whose accuracy is far from assured.

Second, those who reported that their understanding was based on "wishful thinking" (7%) are perhaps saying the management team really doesn't know the firm's value, but they are making decisions as if they do or – more troubling – as they hope it is.

Third, of those who relied on a professional valuation (36% of those who said they knew their firm's value), it is highly likely that it does not correspond to enterprise value. This is because most professional valuations are sought for legal or regulatory purposes (e.g., tax reporting, litigation support, stock option issuance) and thus bear little or no resemblance to actual enterprise value.

One-third of executives rely on professional valuations that bear little resemblance to enterprise value

Finally, when considering all private and public company executives surveyed, only 19% (one in every five) relied on professional valuations by investment bankers, financial advisors or appraisers. Given the other available options (i.e., management estimates, public stock price, or wishful thinking), this implies that valuation professionals are clearly underutilized, which suggests either a misunderstanding of the benefits they offer or a gross lack of confidence in their analyses and conclusions.

Of those private company executives who said they *did not know their firm's value*, the overwhelming response was to skip the question: nearly 80% left it blank. Knowing why they did this is beyond the scope of this survey, but we believe it could mean that they:

- Consider knowing their firm's value unimportant, or

- Were embarrassed that they didn't know and realized they should.

And of those who did answer this short-answer question (21% of private company executives), their answers offered revealing insights about the management culture in their firms (see *Registration Question #4* above for several verbatim responses).

The question of knowing a firm's value is not an academic one. Mission-critical decisions are made regularly, perhaps the greatest being whether to buy or sell all or part of a firm and at what price. Evidence that private companies are routinely sold for less than their intrinsic value (or what can be reasonably attained) is clearly visible in the returns on capital earned by private equity investors, who would not earn excess returns unless they were consistently buying undervalued assets, extracting dividends, and selling them for a profit. And while many private equity investors indeed add value by restructuring balance sheets and operations and enhancing governance, the sellers – while realizing significant wealth upon the sale – are often leaving money on the table.

Evidence that firms are routinely sold for less than fair value is clearly visible in the excess returns earned by private equity investors.

The two Polling Questions probed for responses based on the content of the webinar, which focused on factors influencing corporate value in private firms, not on value measurement. The Polling Questions were posed to both public and private company executives who participated live in the webinar. Therefore, they reflect all types of organizations – not just private companies – and are based on a smaller sample.

Globalization and foreign competition are the most common competitive threats their firms face, accounting for 22% of all replies. The next four, in declining order, were pricing, innovation, insufficient capitalization, and an undifferentiated product line or saturated market. To our surprise, of the 40 executives who answered this Polling Question, regulation and nepotism garnered only one reply each.

With regard to facing these threats in the next two or three years, the survey results probably echo the current state of the capital and merger and acquisition markets, and therefore should be studied again under different market conditions for comparison. Of the 68 executives responding, 29% said they envision their firms acquiring another company while only 12% thought they would be sold to another company; clearly, potential buyers outnumber sellers by more than two-to-one. This reflects, we believe, the currently high "M&A Buzz" in the private company market place and will lead to misguided strategic acquisitions. Indeed, given the plentiful capital and cyclically (if not historically) high prices for acquisition targets, it appears much wiser to be a seller than a buyer.

Buyers outnumber sellers by more than 2:1. This reflects the high "M&A Buzz" in the market place and will lead to misguided acquisitions

With regard to raising capital, 13% said they anticipated issuing shares to a private equity investor while only 3% foresaw an initial public offering of equity. This dichotomy reflects, we believe, the prevailing view that IPOs are now less attractive, given the expense of issuing shares publicly, regulatory burdens (especially from Sarbannes-Oxley), and the plentiful supply of equity and debt funding for private deals.

Finally, given the choice of buying another firm or selling to another, or raising equity capital publicly or privately, 43% of senior financial executives chose none of the above and instead to "stay the course" they're on. This could reflect the conservative nature of most financial executives, but perhaps also a *head in the sand* philosophy, particularly in light of the perceived competitive threats reported.

CONCLUSIONS

Most senior financial executives in private companies do not know what their firms are worth. Nearly 40% reported that they had no idea, while the rest relied on:

- Internal management estimates that are neither independent nor objective;
- Professional valuations that often do not reflect true enterprise value; or
- "Wishful thinking" by the owners about what the value should be.

Moreover, of the 40% who said they didn't know their firm's value, nearly 8 out of 10 *would not say why* they didn't know. This suggests that they consider their firm's value unimportant or they were embarrassed to admit they didn't know it.

And despite significant competitive threats from overseas, as well as weak pricing, undercapitalization and market saturation, most executives unrealistically view their firms as potential acquirers of others, and few are considering new equity capital to invest in growth initiatives.

Given the foregoing, we believe major improvements in management philosophy and practice as they relate to the value and valuation of private firms are urgently needed.

- Peter J. Leitner, Numeria Management LLC and Waterford Advisors LLC

Useful Links:

To see the recorded webinar in its entirety:
https://imanet.webex.com/imanet/onstage/tool/record/viewrecording1.php?EventID=299251256

Waterford Advisors LLC http://www.waterfordadvisors.com
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