Stambaugh Ness

Successful Valuations

Determining Firm Value

During the Ownership Transition process, the question of firm value will inevitably arise – *how will we determine the stock price?* Conducting a formal valuation appraisal can benefit the transition process greatly – it provides a professional, independent opinion of value, and offers the financial framework to the transaction that occurs between willing buyers and sellers.

Valuators have three main methods to choose from: **the Income Approach, the Asset Approach, and the Market Approach.** When selecting an approach, the valuator considers which one is best suited to support the internal transition of ownership interests, taking all known factors into account and all inherent risks and opportunities presented.

A successful valuation starts with a crucial analysis of the historical financial information and an examination of industry trends and norms. A true AE valuation industry expert does a deep dive into the firm's market and clients, assesses the quantity and quality of the organization's work backlog, and benchmarks the firm's performance to that of their peers. For example, for a transportation focused firm, they would consider the outlook for that industry in their state. Or, what if a healthcare-focused firm is in trouble because more hospitals have been built than there are patients to fill them? This kind of information results in a valuation that's both meaningful and actionable. A valuator must see and interpret trends to provide an accurate assessment of a firm's value. Trend data can also help determine if a firm is good at making a profit or has been the beneficiary of outside forces, like the strong economy that the AE industry has enjoyed for the past 11 years.

The result of this analysis helps formulate the specific risks associated with the particular firm and is used in the multipliers, premiums and discounts used to derive value.

Valuation Intangibles

Firm values in the AE industry are highly dependent on the expected future cash flows that can be generated by the firm. The profitability of the firm is a main driver of future cash flows in the valuation process, but it is one of many variables that affect value. Consequently, from a team member perspective, there may not be a clear relationship between profit and stock price. This is particularly true if you haven't educated your employees (i.e., the next generation of owners) about how an AE firm is run.

What matters in the end is how comfortable an employee is with pursuing an ownership stake and making a stock purchase. This is why it is critically important that owners recognize the importance of intangibles.

What team members can relate to, and valuators also consider, are the intangible considerations like:

Growth

If the firm is landing more projects and/or bigger projects, doing more hiring, and creating larger project teams, that is an indicator that the firm's value is increasing. Growth does not always mean higher valuation, but it is true that bigger firms tend to be more insulated from economic events, and therefore are perceived as less of a risk to invest in. We're proponents of efficiency over growth, but growth is an important part of the valuation puzzle.

Diversification

Bringing new expertise into a firm by hiring an industry expert or two so you can break into new markets tends to be a sign of strength. It is a factor in sustainability and mitigation of risk, and that's tangible to employees.

Increasing Selectivity

Most firms have types of projects and/or certain clients that are more challenging than others. The work is difficult, the point person is always asking the firm to justify invoices, etc. Choosing not to pursue new work in those areas and to cut ties with those clients is a sign to employees that owners are running the firm rather than letting it run them. Potential stock purchasers see that principals are concerned not just about the quantity of revenue, but the quality of revenue and making life better for employees.

Marketplace and Client Strength

Positive changes in your firm's position relative to competitors and in the needs and financial resources of your target market—the availability of stimulus money or a city's infrastructure expansion plans, for example—can also support a higher valuation in the minds of employees. Therefore, it can be helpful to share data that you have collected as part of your marketing efforts. This is "safe" information to provide, especially for firms that are not comfortable sharing financial results.

Collaborating For The Most Accurate Number

Ultimately, the best assessment of an AE firm's value comes from the combination of a firm's investment in good financial management, its attention to key metrics, and its collaboration with a valuator who is an industry expert. When those three elements are in place, and if the current owners are willing to educate the next generation, the number generated in a valuation process is one that a firm's principals can use with confidence as they form their strategy for ownership transition in the years to come.