



# The Value of Continuous Improvement

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# Agenda

## **I. The Definition of Value**

## **II. Value Creation Concepts**

## **III. The Value of Continuous Improvement**

# I. The Definition of Value

## How is Value Defined?

- What is Enterprise Value?
- Why does it matter?
- Who says so?

# Valuation Methods

## Valuation Methods:

- 1. Market Method:** *what we often hear in preliminary negotiations*
- 2. Income Method:** *what we see used most frequently in Corporate Board Rooms and in final negotiations*
- 3. Replacement Cost:** *what we often see in highly distressed transactions*

# Valuation Methods: Market

## The Market Method (“Comps”)

*What we often hear in preliminary negotiations*

### Assumptions:

- There exists a trading market for companies similar to yours
- Your company should trade at a price comparable to those that are similar to yours

### Formula:

**EBITDA Multiple:**  $[\text{Enterprise Value}] / [\text{EBITDA}]$

**Revenue Multiple:**  $[\text{Enterprise Value}] / [\text{Revenue}]$

# Valuation Methods: Market

“ Comps ”

| Date   | Buyer   | Company Sold | Price (\$MM) | Revenue (\$MM) | Revenue Multiple | EBITDA | EBITDA Multiple |
|--------|---------|--------------|--------------|----------------|------------------|--------|-----------------|
| Dec-07 | Example | Example      | 74.6         | 76.3           | 1.0              | 9.3    | 8.0             |
| Dec-07 | Example | Example      | 45.0         | 49.3           | 0.9              | 6.1    | 7.4             |
| Nov-07 | Example | Example      | 8.0          | 14.1           | 0.6              | 1.0    | 8.0             |
| Sep-07 | Example | Example      | 78.0         | 64.5           | 1.2              | 7.0    | 11.1            |
| Jun-07 | Example | Example      | 29.2         | 25.2           | 1.2              | 3.8    | 7.7             |
| Jun-07 | Example | Example      | 19.0         | 15.8           | 1.2              | 3.2    | 6.0             |
| May-07 | Example | Example      | 72.4         | 36.4           | 2.0              | 5.8    | 12.5            |
| May-07 | Example | Example      | 51.0         | 52.7           | 1.0              | 6.0    | 8.5             |
| Apr-07 | Example | Example      | 108.0        | 150.3          | 0.7              | 19.6   | 5.5             |
| Feb-07 | Example | Example      | 103.0        | 88.6           | 1.2              | 14.2   | 7.3             |
| Feb-07 | Example | Example      | 17.5         | 14.0           | 1.3              | 1.9    | 9.2             |
| Jan-07 | Example | Example      | 36.0         | 55.0           | 0.7              | 5.5    | 6.5             |
| Dec-06 | Example | Example      | 110.5        | 124.2          | 0.9              | 17.9   | 6.2             |
| Dec-06 | Example | Example      | 34.2         | 45.1           | 0.8              | 4.7    | 7.3             |
| Oct-06 | Example | Example      | 43.9         | 32.0           | 1.4              | 5.1    | 8.6             |
| Aug-06 | Example | Example      | 73.0         | 43.7           | 1.7              | 9.8    | 7.4             |
| Jun-06 | Example | Example      | 16.3         | 29.6           | 0.6              | 2.7    | 6.0             |
| Jun-06 | Example | Example      | 15.4         | 15.5           | 1.0              | 2.8    | 5.5             |
| May-06 | Example | Example      | 102.0        | 101.1          | 1.0              | 9.7    | 10.5            |
| Etc    |         |              |              |                |                  |        |                 |
|        |         | Average      | \$ 54.6      | \$ 54.4        | 1.1              | \$ 7.2 | 7.9             |

# Valuation Methods: Market

## EBITDA Multiple

|         |  | Multiple |     |     |      |      |
|---------|--|----------|-----|-----|------|------|
|         |  | 4.0      | 6.0 | 8.0 | 10.0 | 12.0 |
| \$ 2.0  |  | 8        | 12  | 16  | 20   | 24   |
| \$ 4.0  |  | 16       | 24  | 32  | 40   | 48   |
| \$ 6.0  |  | 24       | 36  | 48  | 60   | 72   |
| \$ 8.0  |  | 32       | 48  | 64  | 80   | 96   |
| \$ 10.0 |  | 40       | 60  | 80  | 100  | 120  |

**Example: EBITDA of \$4,000,000 at 8X = \$32,000,000**

# Valuation Methods: Market

## Revenue Multiple

|         |          | Multiple |     |     |     |     |
|---------|----------|----------|-----|-----|-----|-----|
|         |          | 0.8      | 0.9 | 1.0 | 1.1 | 1.2 |
| Revenue | \$ 10.0  | 8        | 9   | 10  | 11  | 12  |
|         | \$ 25.0  | 20       | 23  | 25  | 28  | 30  |
|         | \$ 50.0  | 40       | 45  | 50  | 55  | 60  |
|         | \$ 75.0  | 60       | 68  | 75  | 83  | 90  |
|         | \$ 100.0 | 80       | 90  | 100 | 110 | 120 |

**Example: Revenue of \$25,000,000 at 1.1X = \$28,000,000**

## Valuation Methods: Market

### Value Based on “Comps”

|                                  |                          |
|----------------------------------|--------------------------|
| <b>Based on EBITDA Multiple</b>  | <b>32,000,000</b>        |
| <b>Based on Revenue Multiple</b> | <b>28,000,000</b>        |
| <b>Simple Average</b>            | <b><u>30,000,000</u></b> |

# Valuation Methods: Income

## Income Method

Assumes investors will formulate their view of the value of a business based upon their expectation of the future distributions they will receive from that business (“Free Cash Flow”).

The buyer’s view of the company’s future performance is the single most critical variable under the income valuation method.

Value = Discounted [  $\Sigma$  CFO<sub>1</sub> + CFO<sub>2</sub> + CFO<sub>3</sub>..... ]

# Valuation Methods: Income

|                      |               |                |                 |
|----------------------|---------------|----------------|-----------------|
| <b>Discount Rate</b> | <b>14.00%</b> | Valuation Date | <b>1/1/2008</b> |
|----------------------|---------------|----------------|-----------------|

|                          |             |
|--------------------------|-------------|
| <b>Terminal Multiple</b> | <b>8.00</b> |
|--------------------------|-------------|

| <b>Free Cash Flow</b>                | 12/31/2008   | 12/31/2009   | 12/31/2010   | 12/31/2011   | 12/31/2012   |
|--------------------------------------|--------------|--------------|--------------|--------------|--------------|
| <b>Distributions to Shareholders</b> | <b>3,500</b> | <b>4,000</b> | <b>4,250</b> | <b>4,750</b> | <b>5,500</b> |

| <b>Terminal Value</b>    | 12/31/2012          |
|--------------------------|---------------------|
| Free Cash Flow           | 5,500               |
| <i>Terminal Multiple</i> | <b>8.00</b>         |
|                          | <hr/> 44,000        |
| Net Debt at Exit         | 6,774               |
| Terminal Value           | 37,226              |
| Capital Gain Tax         | -7,445              |
| Distribution             | <hr/> <b>29,781</b> |

| <b>Discounted Values</b>  | 12/31/2008     | 12/31/2009     | 12/31/2010     | 12/31/2011     | 12/31/2012      |
|---------------------------|----------------|----------------|----------------|----------------|-----------------|
| Year                      | 1              | 2              | 3              | 4              | 5               |
| Discount Factors          | 1.14           | 1.30           | 1.48           | 1.69           | 1.93            |
| Nominal Cash Flows        | 3,500          | 4,000          | 4,250          | 4,750          | 35,281          |
| Discounted Free Cash Flow | <b>\$3,070</b> | <b>\$3,078</b> | <b>\$2,869</b> | <b>\$2,812</b> | <b>\$18,324</b> |

|                              |                 |
|------------------------------|-----------------|
| <b>Enterprise Value</b>      | <b>\$30,153</b> |
| Net Debt                     | (\$6,774)       |
| <b>Value of Common Stock</b> | <b>\$23,379</b> |

# Valuation Methods: Replacement Cost

## Replacement Cost Method

*What we often see in highly distressed transactions*

Assumes that the value of a business is equal to the cost to replace the business in its entirety, including “Goodwill”.

### Sample Goodwill Items:

- Intangible assets
- Trade names
- Intellectual property
- Patents
- Unique process and knowledge
- Customer relationships
- Customer approvals
- Governmental licenses
- Certificates and approvals
- Customer lists
- Supplier relationships
- All other ‘intangible’ aspects of the business

# Valuation Methods: Replacement Cost

## Valuing Intangibles / Goodwill

Based on the direct and indirect costs to recreate the exact asset

- Process know how
- Customer contracts
- Supplier contracts
- Customer relationships/lists
- Approvals
- Etc

# Valuation Methods: Replacement Cost

## Goodwill Example Value of “Sheet Metal Process Know-how”

| <b>Cash Flows (\$000)</b>            | <b>1</b> | <b>2</b> | <b>3</b> | <b>4</b> | <b>5</b> | <b>6</b> | <b>7</b> | <b>8</b> | <b>9</b> | <b>10</b>    |
|--------------------------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|--------------|
| Trainers and Consultants             | (65)     | (45)     | (25)     | (5)      | (6)      | (6)      | (7)      | (7)      | (8)      | (9)          |
| Hiring Costs                         | (50)     | (25)     | (8)      | (8)      | (9)      | (10)     | (11)     | (12)     | (13)     | (14)         |
| Cost of Manuals                      | (25)     | (15)     | (11)     | (11)     | (12)     | (13)     | (15)     | (16)     | (18)     | (19)         |
| Direct Labor Costs                   | (100)    | (150)    | (250)    | (500)    | (550)    | (900)    | (1,010)  | (1,350)  | (2,000)  | (3,000)      |
| Material Costs                       | (100)    | (125)    | (500)    | (400)    | (500)    | (750)    | (770)    | (800)    | (2,500)  | (3,000)      |
| Sheet Metal Revenues                 | -        | -        | 500      | 1,000    | 1,250    | 1,500    | 2,500    | 5,000    | 8,000    | 9,000        |
| Net Cash Flows                       | (340)    | (360)    | (294)    | 76       | 174      | (179)    | 688      | 2,815    | 3,461    | 2,957        |
| <b>Discounted Values (r = 14%)</b>   |          |          |          |          |          |          |          |          |          |              |
| Discount Factors                     | 1.14     | 1.30     | 1.48     | 1.69     | 1.93     | 2.19     | 2.50     | 2.85     | 3.25     | 3.71         |
| Discounted Free Cash Flow            | (\$298)  | (\$277)  | (\$198)  | \$45     | \$90     | (\$82)   | \$275    | \$987    | \$1,064  | \$798        |
| <b>Value of Sheet Metal Know-how</b> |          |          |          |          |          |          |          |          |          | <b>2,404</b> |

# Valuation Methods: Replacement Cost

## Value Based on Replacement Cost

|                     |                   |
|---------------------|-------------------|
| Accounts Receivable | 5,347,981         |
| Inventory           | 4,163,937         |
| PP&E                | 5,313,905         |
| Goodwill            | 6,492,726         |
| Total               | <u>21,318,549</u> |

## II. Value Creation Concepts

## How is Value Created?

By increasing expected future  
free cash flow

## Increasing Free Cash Flow

- Reduce process waste
- Reduce scrap materials
- Increase revenue on fixed labor
- Increase gross profit
- Increase daily throughput
- Reduce overheads

# Value Creation Concepts

## Increasing Expected Future Free Cash Flow:

- **Raise Earnings:** More profit = more cash flow
- **Raise the Confidence Level:** The greater the uncertainty of the future cash flows the higher the discount rate.
- **Reduce Working Capital:** Less cash tied-up in Inventory and Receivable
- **Reduce Capital Expenditures:** Less cash tied up in plant and equipment

# III. The Value of Continuous Improvement

# Value of Continuous Improvement: Examples

## Example: Value of Reduced Uncertainty

**Discount Rate Reduced by 2%** **12.00%** Valuation Date **1/1/2008**

**Terminal Multiple** **8.00**

| <b>Free Cash Flow</b>                | 12/31/2008   | 12/31/2009   | 12/31/2010   | 12/31/2011   | 12/31/2012   |
|--------------------------------------|--------------|--------------|--------------|--------------|--------------|
| <b>Distributions to Shareholders</b> | <b>3,500</b> | <b>4,000</b> | <b>4,250</b> | <b>4,750</b> | <b>5,500</b> |

| <b>Terminal Value</b>    | 12/31/2012          |
|--------------------------|---------------------|
| Free Cash Flow           | 5,500               |
| <i>Terminal Multiple</i> | <b>8.00</b>         |
|                          | <hr/> 44,000        |
| Net Debt at Exit         | 6,774               |
| Terminal Value           | 37,226              |
| Capital Gain Tax         | -7,445              |
| Distribution             | <hr/> <b>29,781</b> |

| <b>Discounted Values</b>  | 12/31/2008     | 12/31/2009     | 12/31/2010     | 12/31/2011     | 12/31/2012      |
|---------------------------|----------------|----------------|----------------|----------------|-----------------|
| Year                      | 1              | 2              | 3              | 4              | 5               |
| Discount Factors          | 1.12           | 1.25           | 1.40           | 1.57           | 1.76            |
| Nominal Cash Flows        | 3,500          | 4,000          | 4,250          | 4,750          | 35,281          |
| Discounted Free Cash Flow | <b>\$3,125</b> | <b>\$3,189</b> | <b>\$3,025</b> | <b>\$3,019</b> | <b>\$20,019</b> |

|                              | Prior Value     | Value Created |
|------------------------------|-----------------|---------------|
| <b>Enterprise Value</b>      | \$32,377        | \$ 30,153     |
| Net Debt                     |                 | (\$6,774)     |
| <b>Value of Common Stock</b> | <b>\$25,603</b> |               |

# Value of Continuous Improvement: Examples

## Example: Value of Faster Inventory Velocity

Discount Rate **14.00%** Valuation Date **1/1/2008**

Terminal Multiple **8.00**

| Free Cash Flow                | 12/31/2008 | 12/31/2009 | 12/31/2010 | 12/31/2011 | 12/31/2012 |
|-------------------------------|------------|------------|------------|------------|------------|
| Distributions to Shareholders | 3,500      | 4,000      | 4,250      | 4,750      | 5,500      |
| Reduction in Inventory        | 500        | 600        | 675        | 800        | 850        |
| Total Distributions available | 4,000      | 4,600      | 4,925      | 5,550      | 6,350      |

| Terminal Value    | 12/31/2012    |
|-------------------|---------------|
| Free Cash Flow    | 6,350         |
| Terminal Multiple | <b>8.00</b>   |
|                   | 50,800        |
| Net Debt at Exit  | 6,774         |
| Terminal Value    | 44,026        |
| Capital Gain Tax  | -8,805        |
| Distribution      | <b>35,221</b> |

| Discounted Values         | 12/31/2008     | 12/31/2009     | 12/31/2010     | 12/31/2011     | 12/31/2012      |
|---------------------------|----------------|----------------|----------------|----------------|-----------------|
| Year                      | 1              | 2              | 3              | 4              | 5               |
| Discount Factors          | 1.14           | 1.30           | 1.48           | 1.69           | 1.93            |
| Nominal Cash Flows        | 4,000          | 4,600          | 4,925          | 5,550          | 41,571          |
| Discounted Free Cash Flow | <b>\$3,509</b> | <b>\$3,540</b> | <b>\$3,324</b> | <b>\$3,286</b> | <b>\$21,591</b> |

|                       | Prior Value | Value Created |
|-----------------------|-------------|---------------|
| Enterprise Value      | \$35,249    | \$ 30,153     |
| Net Debt              |             | (\$6,774)     |
| Value of Common Stock | \$28,475    |               |

# Value of Continuous Improvement: Examples

## Example: Value of Better Machine Utilization

14.00% Valuation Date 1/1/2008

Terminal Multiple 8.00

| Free Cash Flow                | 12/31/2008 | 12/31/2009 | 12/31/2010 | 12/31/2011 | 12/31/2012 |
|-------------------------------|------------|------------|------------|------------|------------|
| Distributions to Shareholders | 3,500      | 4,000      | 4,250      | 4,750      | 5,500      |
| Reduced Capital Expenditures  | 600        | 825        | 550        | 650        | 450        |
| Total Distributions available | 4,100      | 4,825      | 4,800      | 5,400      | 5,950      |

| Terminal Value    | 12/31/2012 |
|-------------------|------------|
| Free Cash Flow    | 5,950      |
| Terminal Multiple | 8.00       |
|                   | 47,600     |
| Net Debt at Exit  | 6,774      |
| Terminal Value    | 40,826     |
| Capital Gain Tax  | -8,165     |
| Distribution      | 32,661     |

| Discounted Values         | 12/31/2008 | 12/31/2009 | 12/31/2010 | 12/31/2011 | 12/31/2012 |
|---------------------------|------------|------------|------------|------------|------------|
| Year                      | 1          | 2          | 3          | 4          | 5          |
| Discount Factors          | 1.14       | 1.30       | 1.48       | 1.69       | 1.93       |
| Nominal Cash Flows        | 4,100      | 4,825      | 4,800      | 5,400      | 38,611     |
| Discounted Free Cash Flow | \$3,596    | \$3,713    | \$3,240    | \$3,197    | \$20,053   |

|                       | Prior Value | Value Created |
|-----------------------|-------------|---------------|
| Enterprise Value      | \$33,799    | \$ 30,153     |
| Net Debt              |             | (\$6,774)     |
| Value of Common Stock |             | \$27,025      |

# Conclusion

1. Who Defines Value? **The Buyers**
2. How is Value Defined? **Discounted Future Free Cash Flow**
3. How is Value Created? **By Increasing Expected Future Free Cash Flow**

OBJECTIVITY . CLARITY . CLIENT SUCCESS

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