

Chapter 4: Business Valuation

In this section, we will take three approaches to valuing a family entertainment center. These approaches are the: (1) cost (asset based), (2) market, and (3) income approach. The cost approach section focuses on the adjustments and nuances of making balance sheet adjustments, while the market approach values the subject company based on market multiples. Lastly, the income approach will provide a “reality check” as to the value of the company based on cash flows.

Adjusted Balance Sheet (Business Valuation)

Overall, this valuation method is used to value a company as a going concern. However, it has a number of shortcomings, in that it does not consider intangible assets such as: assembled workforce, trademarks, customer lists, technical know how, etc. Most importantly, if a buyer were to “start the business from scratch,” then this buyer would probably purchase all of the assets at a liquidation value. In summary, this valuation methodology is most important to the insurance industry and financial lenders, and usually represents the floor value of a business.

As an example of an adjusted book methodology, look at Table 4-4 and compare the adjusted book value of \$15,405,139 to the values concluded by the market approach (\$23,694,523-see Table 4-11 on page 88), and the concluded value of the income approach (\$22,309,664-in Table on page 94). It must be noted that not all companies indicate such a range in values.

With the adjusted balance sheet method, goodwill should also be factored in. Most companies sell for their adjusted book value plus a premium of zero to two times EBITDA. For our subject company, this would result in a premium (goodwill value) of \$1,404,636 multiplied by two to equal an additional \$2,809,272 of value. Total invested capital would equal \$21,850,902 [$\$19,632,388 - 607,958 + 21,200 + (4,000) + \$2,809,272$] and after subtracting out the \$3,636,491 of interest bearing debt, the equity value would be \$18,214,411 ($\$15,405,139 + \$2,809,272$ in adjusted goodwill).

Goodwill

Table 4-4: Sample Adjusted Balance Sheet of Our Family Entertainment Center

	Book Value	Adjustment	Market Value
Assets			
Current Assets			
Cash & Equivalents	\$63,333		\$63,333
Inventory	57,964		57,964
Other Current Asset	161,091		161,091
Total Current Assets	282,388		282,388
Gross Fixed Assets			
Market Value of Real Estate	-	19,000,000	19,000,000
Land and Building	1,911,993	(1,911,993)	-
Equipment & Machinery	811,757	(461,757)	350,000
Total Gross Fixed Assets	2,723,750	16,626,250	19,350,000
Depreciation	(1,315,800)	1,315,800	-
Net Fixed Assets	1,407,950	17,812,050	19,350,000
Other Assets	2,621,075	(2,621,075)	-
Total Assets	\$4,311,413	15,320,975	\$19,632,388
Liabilities & Equity			
Current Liabilities			
Accounts Payable Trade	59,727		59,727
Accrued Liabilities	490,939		490,939
Notes Payable - Current	(4,000)		(4,000)
Current Long Term Debt	21,200		21,200
Unearned Revenue	40,091		40,091
Total Current Liabilities	\$607,958		\$607,958
Long Term Debt	3,398,200		3,398,200
Other Noncurrent Liabilities	221,091		221,091
Total Liabilities	4,227,249	-	4,227,249
Shareholders' Equity	84,164	15,320,975	15,405,139
Total Liabilities and Equity	\$4,311,413	15,320,975	\$19,632,388

Market Approach (Business Valuation)

Before applying the market multiples we need to adjust the cash flow of the subject family entertainment center, adjusting rent to levels that represent market rates. These adjustments allow us to compare apples with apples when comparing our subject family entertainment center with the other, privately held family entertainment centers which typically operate under a lease. Publicly held amusement parks tend to own their real estate, which allows for a direct

comparison between the subject and public companies. Facilities operating under a lease will have lower asset and equity values due to that component not being represented in the balance sheet. Also, depending on the terms of the lease, a lessor might be subject to rent increases as the market goes up. With our subject family entertainment center, the lease payments were paid to itself through a separate holding company. Had it been leasing from a different company, paying fair market rental rates, it most likely would not have been able to continue operating where it is located.

Table 4-5: Adjustments to Income Statement For Subject FEC

	2006	2005
Income Before Taxes*	\$479,586	\$456,732
Depreciation & Amortization (Equip)	434,825	442,375
Interest Expense (Operations)*	490,225	574,075
Unadjusted EBITDA	1,404,636	1,473,182
Plus: Discretionary Expenses	58,536	57,431
Plus: Actual Rent	1,302,677	1,302,677
Less: Fair Market Rent**	(1,908,500)	(1,908,500)
Adjusted EBITDA (leasehold cash flow)	\$857,349	\$924,790
Unadjusted Cash Flow	\$914,411	\$899,107
Plus: Discretionary Expenses	58,536	57,431
Plus: Actual Rent	1,302,677	1,302,677
Less: Fair Market Rent**	(1,908,500)	(1,908,500)
Adjusted Cash Flow (leasehold)	\$367,124	\$350,715
Unadjusted EBITDA	\$1,404,636	\$1,473,182
Plus: Discretionary Expenses	58,536	57,431
Plus: Actual Rent	1,302,677	1,302,677
Adjusted EBITDA (fee simple cash flow)	\$2,765,849	\$2,833,290
Unadjusted Cash Flow	\$914,411	\$899,107
Plus: Discretionary Expenses	58,536	57,431
Plus: Actual Rent	1,302,677	1,302,677
Adjusted Cash Flow (fee simple)	\$2,275,624	\$2,259,215

* Figures are taken from the balance sheet and income statements found in Table 2-4 on page 50 and Table 2-3 on page 49.

** Fair Mkt Rent = Real Estate Value (19,085,000) x Capitalization Rate (0.1000) = \$1,908,500

Facilities not on a lease will own the real estate, and in many cases, benefit from ownership through appreciation of real estate value over time. As long as the mortgage rates are favorable, and do not put the facility in a position of possible default, then this situation is ideal for the operator. When the operator chooses to sell the operation, he or she will always know that the amount of money he receives will be buffered by the real estate value less any outstanding debt. In a situation where there is high real estate appreciation, this can greatly increase the value of the operations, as it did with our subject company. Lastly, it must be noted, that as an operator pays off the long term debt due on the real estate, the book value of equity will increase over time relative to a lessor – this is under the assumption that most retained earnings would not be left in the company, but rather be kept by the owner.

Adjustments of Cash Flow

A summary of the adjustments made to the cash flows can be seen in Table 4-5 on page 83. This cash flow is taken from the example in Table 2-3 on page 49 of our subject family entertainment center.

As can be seen from Table 4-5 on page 83, we need to adjust the cash flow for adjustments made by the owner’s personal discretionary expenses as well as changes in market rent. We used a yield rate of 10.0% to calculate market rent of our subject family entertainment center (see Table 5-16 on page 115).

Table 4-6: Comparative Ratios as a % of Assets & Income (Unadjusted)

	Subject	Company 1 (Cedar Fairs)	Company 2 (Six Flags)
<i>Balance Sheet</i>			
Total Assets (%)	100%	100%	100%
Cash & Equivalents	1.5	1.2	0.8
Inventory	1.3	1.1	0.7
Current Assets	6.5	4.2	4.2
Net Fixed Assets	32.7	79.1	60.7
Current Liabilities	14.1	6.3	9.1
Long Term Debt	78.8	68.5	66.7
Net Worth	2.0	23.8	20.9
Working Capital	-7.0	-2.2	-5.0
Total Assets (\$000)	\$4,311	\$2,510,921	\$3,187,616
<i>Income Statement</i>			
Revenue (%)			
Pre-tax Income	9.7	15.8	-13.0
Net Income	6.3	11.1	-13.4
Cash Flow	18.5	32.6	21.7
EBITDA	28.4	37.3	22.1
Revenue (\$000)	\$4,947	\$831,400	\$945,665

Source: Primary Income Statements and Balance Sheets

Using public company information gathered through various resources and comparing this to our sample company, whose balance sheet and income statements are in Table 2-4 on page 50, and in Table 2-3 on page 49, shown earlier, we can contrast differences between the subject company and the market comparables. The subject company is a family entertainment center with only one location. It must be noted that the comparables have not been adjusted for items such as differences in inventory practices, intangible assets or off balance sheet financing, depreciation or capital structure.

Publicly Traded Information

Table 4-8 shows the breakdown of the various components of the company which make up the returns on equity (ROE), based upon a DuPont analysis. The reader will recall that this overview is critical for understanding which component drives the equity return. These ratios are more fully described in the section “DuPont Model” on page 57.

Table 4-7: Financial & Operating Ratio Analysis (Unadjusted)

	Subject	Company 1 (Cedar Fairs)	Company 2 (Six Flags)
<i>Activity Ratios</i>			
Days Inventory Held	75.1	N/A	106
Debt Free Working Capital Turnover	-27.2	-6.6	-6.0
Days of Working Capital	n/a	-24	-61
Net Fixed Assets Turnover	2.97	0.4	0.5
<i>Liquidity Ratios</i>			
Current Ratio	0.46	0.7	0.7
Quick Ratio	0.10	0.3	0.5
<i>Solvency Ratios</i>			
Debt:Equity	43.21	2.9	3.4
Times Interest Earned	1.98	2.5	0.4
<i>Profitability Ratios</i>			
ROE Margin*	370.4	55.7	-19.1
ROA Margin (after-tax)	16.5	49.8	-4.0
EBITDA Margin	28.4	37.3	22.1
Pre-tax Margin	9.7	15.8	-13.0
Profit Margin	6.3	11.1	-13.4

* It must be noted that the ROE margins differ from comparable public companies because of the debt structure of the subject family entertainment center's underlying ownership of real estate and the mortgage debt levels.

A summary of our concluded values can be seen in Table 4-11 on page 88. The interest bearing debt consists of business long term debt of \$3,398,200 + \$221,091 + 21,200 - 4,000 = \$3,636,491 (This information is taken from Table 2-4 on page 50 and Table 2-3 on page 49). As shown in Table 4-11 on page 88, we have concluded a value of \$7,620,850 for the total invested capital (net of real estate) and \$3,509,797 equity value (net of real estate).