

UNDERSTAND THE VALUE OF YOUR
**AGRICULTURAL EQUIPMENT
AND MACHINERY DEALERSHIP**

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It is inevitable; all successful businesses eventually undergo some form of ownership transition. People do not live forever, so businesses must be passed on in one way or another. There are numerous scenarios under which such transitions occur; however, all transitions must invariably address the question of value.

The purpose of this article is to provide an informative overview regarding the valuation of agricultural equipment and machinery dealerships.

A lack of knowledge regarding the value of your business could be very costly. Opportunities for successful liquidity events may be missed or estate planning could be incorrectly implemented based on misunderstandings about value. In addition, understanding how equipment and machinery dealerships are valued may help you understand how to grow the value of your business and maximize your return when it comes time to sell.

WHEN DO YOU NEED TO KNOW WHAT YOUR BUSINESS IS WORTH?

SELLING OUT?

In the most obvious case, someone who is planning to sell their business needs to know what it is worth. Probably the hardest issue a business owner encounters is cashing-out their life's work. Beyond the myriad of emotional issues you will face is the raw economics of how you will sell and for how much. There are hundreds of issues that may arise in a transaction. Many of them ultimately affect the proceeds of the transaction to the seller. Knowing what you should be able to expect will let you evaluate whether or not an offer for your company is reasonable.

SELLING IN?

If you are planning on transferring ownership to your children or your management team, you will need to know what the interests in the business being transferred are worth. Given taxes and other, this may be much less than a pro rata interest in the total value of the business. Ignoring this issue can cost you a lot of money.

BUY-SELL AGREEMENTS

Many business owners fail to understand the valuation implications of buy-sell agreements. If you have other shareholders in your business who are non-family, and maybe some who are, you probably have some kind of buy-sell agreement between the shareholders that describes how the business (or business interests) will be valued in the event of a shareholder dispute, death, or departure from the business (even on friendly terms).

In our experience, buy-sell agreements almost never sufficiently describe the mechanism to be used to value the business. The process looks simple when the buy-sell agreement is being drafted and a transaction is not on the table. However, when the day comes that a buy-sell agreement is invoked, you will want the process delineated very clearly.

OTHER OWNERSHIP TRANSFER SCENARIOS

Mercer Capital developed the *Ownership Transfer Matrix* to illustrate the universe of ownership transition scenarios. Most business owners are consumed with day-to-day activities of running the business. Many fail to acknowledge that life (and business) cycle events do happen to them, their partners and their families and that these events will require that their businesses be valued.

Alternatively, some business owners use business valuation as an essential tool for creating ownership stability and assessing management performance. Mercer Capital professionals have spoken for years about the “things that happen to you” and the “things you make happen.” Our essential point is this: an understanding of the value of your business or business interest is critical in preparing yourself for any of these eventualities.

The Ownership Transfer Matrix	PARTIAL SALE/TRANSFER	TOTAL SALE/TRANSFER
THINGS YOU MAKE HAPPEN	ESOP Outside Investor(s) Sale to Insiders/Family Combination Merger/Cash Out Going Public	Sale of Business Stock-for-Stock Exchange w/ Public Co. Stock Cash Sale to Public Co. Installment Sale to Insiders/Family ESOP/Management Buyout
THINGS THAT HAPPEN TO YOU	Death Divorce Forced Restructuring Shareholder Disputes	Death Divorce Forced Restructuring Bankruptcy

VALUE MANAGEMENT

Maybe you are not currently contemplating a transaction in your business. You do not plan to sell in the next few years, you are not planning on transferring it to your children, you are not entering into any buy-sell agreements or shareholder agreements based on the value of the business, nor do you anticipate any of the other events listed in the *Ownership Transfer Matrix*. Then why do you care? Because knowing the value of your business can be a tremendously effective management tool.

Ultimately, you will get two returns from your business – what we in the valuation community call “interim cash flows” and “terminal cash flows.” Interim cash flows might be your salary, your benefits, and your dividends. You know what these are and what you can do to influence them. However, your biggest cash flow may be the terminal cash flow – when you go to sell your business. Are you managing your business in a way that increases its value or not? Do you know?

BASIC CONCEPTS THAT MUST BE DEFINED IN EVERY VALUATION

Before covering specific details related to the agricultural equipment dealerships, it is important to understand basic concepts related to the valuation analysis.

It comes as a surprise to many business owners to learn that there is not a single value for their business. Numerous factors (legal, tax or otherwise) play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

THE VALUATION DATE

Every valuation has an “as of” date, which simply means that it is the date around which the analysis is focused. The date may be set by legal requirements related to a death or divorce, or be implicit, such as the closing date of a transaction.

THE PURPOSE OF THE VALUATION

The purpose of the valuation is important because it is linked to the transfer event (such as a sale, estate planning, etc.). A valuation prepared for one purpose is not necessarily useful or applicable for another.

THE STANDARD OF VALUE

The standard of value is an important legal concept that must be addressed in every valuation assignment. “Fair market value,” most commonly used in tax matters, is the most familiar standard of value. Other important standards of value are “investment value” (purchase and sale transactions), “statutory fair value” (corporate reorganizations), and “intrinsic value” (public securities analysis). Using the proper standard of value is crucial in obtaining an accurate determination of value. The standard of value will influence the selection of valuation methods, as well as the level of value.

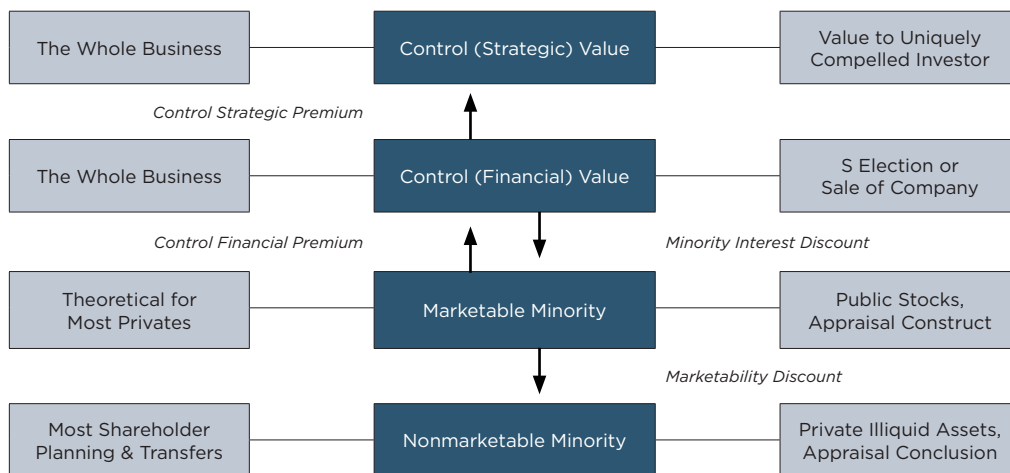
THE LEVELS (PREMISE) OF VALUE

Does it make a difference in value per share if you own 10% or 75% of a business? You bet it does. The former is a minority interest and does not enjoy the prerogatives of control that the latter does. How does this affect value per share? The minority owners are relegated to bearing witness to a process over which they have no control or discretion. In effect, they often play the role of silent partners. They cannot control compensation or distributions, and they certainly cannot dictate the strategic direction or operational management of the business. Thus, the fair market value per share of a minority owner is likely worth less per share than the shares of a 75% owner.

To add further insult to injury, a minority owner of a private business likely has no ready market in which to sell their interest. Minority ownership in a publicly traded company enjoys near instantaneous liquidity given that such interests can be traded on organized and regulated exchanges. The unique uncertainties related to the timing and favorability of converting a private, minority ownership interest to cash gives rise to a valuation discount (marketability) which further distances the minority owner's per share value from that of a controlling owner's value per share.

The following chart provides perspective of the various levels of value. In most cases a valuation is developed at one level of value and then converted to another level of value by way of a discount or premium. Knowing when to apply such adjustments and quantifying the size of these adjustments is no simple matter.

What does all this have to do with your business? A lack of basic knowledge of these concepts can leave you short of the required vocabulary and understanding needed to comprehend the context with which the value of a business interest is developed.



IMPORTANT INDUSTRY FACTORS

A review of the agricultural equipment and machinery industry is important in establishing a credible value for a business operating in this space. Such a review should consider a wide range of issues (far too many to list in full here), with primary considerations as outlined below.

- » **Performance and market positioning of affiliated manufacturer(s).** Most equipment dealers have franchise agreements with one or multiple manufacturers to maintain and sell the equipment of that particular manufacturer. The level of dependence on the manufacturer cannot be overstated. The general market positioning of the affiliated manufacturer (be it John Deere, Case IH, or another manufacturer) is of substantial importance to the ongoing business prospects of the subject dealer. The quality of the manufacturer's equipment and the acceptance of the products within the market are critical factors over which the subject dealership likely will have little to no control.
- » **Conditions for farmers within a dealership's geographic area.** Obviously, the potential customer base for any farm equipment dealer generally comprises the farming market within its geographic area. Any factors that impact this group's demand for equipment, parts, and services can have an impact on the dealership's business, especially in the short-term. Specific factors to consider include commodity pricing (both output and input prices), weather conditions, government subsidies, etc.
- » **Competition within a dealership's market.** One of the primary benchmarks for performance of an equipment dealer is market share. Market share is a broad measure of how a particular dealership is operating versus its competition in its geographic area. The relative strength or weakness of competitors can have a significant impact on both the current level of profits within a dealership and the expectations of future growth for the business. While a higher current market share can be a sign of strength for a dealership, a lower current share could be evidence of future growth opportunities. A detailed analysis of the competitive landscape for the dealership is a critical component in a comprehensive valuation assessment.

FINANCIAL CONSIDERATIONS

When valuing a business, it is critical to understand the subject company's financial condition. A financial analyst has certain diagnostic markers that tell much about the condition of a business.

- » **Historical growth in sales and profitability.** One of the primary factors impacting the value of any business is the level of growth expected going forward. Often the best indicator of future growth is growth over the recent history. It is important for an analyst to understand not only whether growth is occurring, but also what factors are driving the growth. Has the dealership implemented a new marketing or sales strategy? Have competitors weakened or gone out of business? Has the dealership expanded certain areas of the business to take advantage of demand for certain services (such as parts and service)?

- » **Profit margins.** While sales can be a good indicator of the direction of a business, actual benefits to business owners are driven by profits. After all expenses of a business are paid, the residual amount represents the return available to shareholders. An important measure of a Company's performance across time is its profit margin. Margins can be analyzed at different levels of the income statement to focus on different aspects of the dealership's cost and expense structure (gross profit, EBITDA, operating income, net income). Margins can also be compared to industry averages to analyze a dealership's performance relative to its peers and to identify potential areas of future improvement.

- » **Divisional sales and profit breakdown.** Most agricultural equipment dealerships sell new and used agricultural machinery, sell parts for such equipment and provide servicing and maintenance. Analyzing the level of profit contribution from each part of the business is a key step in understanding the business and assessing expectations going forward. Generally, while sales figures are skewed toward equipment sales, profit measures are typically more evenly spread. It is not uncommon for a dealership's parts and service departments to be the most profitable parts of its business.

- » **Balance sheet considerations.** The nature of the dealership business requires a robust balance sheet given the substantial required investment in assets such as inventory and accounts receivable. The more efficient the dealership is at managing these balance sheet requirements, generally the more cash flow (and value) the dealership will have. Balance sheet efficiency can be analyzed both relative to a specific dealership's historical patterns and relative to other operators in the industry. Any balance sheet measure that is substantially outside of industry norms will need to be analyzed and understood in order to assess what impact it might have on the ongoing operations of the business. It is also important to assess whether reported asset balances are accurate measures of the actual market value for the underlying asset. Specific to equipment dealers, the inventory category is one area where the question of market value can be most critical.

HOW DOES VALUATION WORK?

As mentioned previously, it comes as a surprise to many owners to learn that there is not a single value for their business. Numerous legal factors play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose here is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

Without offering a full dissertation on business valuation, you need to understand that there are fundamentally three commonly accepted approaches to value: asset-based, market, and income. Approaches refer to the basis upon which value is measured.

Each approach incorporates procedures that may enhance awareness about specific business attributes that may be relevant to determining the final value. Ultimately, the concluded valuation will reflect consideration of one or more of these approaches (and perhaps several underlying methods) as being most indicative of value for the subject interest under consideration.

THE ASSET-BASED APPROACH

The asset-based approach can be applied in different ways, but in general it represents the market value of a company's assets minus the market value of its liabilities.

Investors make investments based on perceived required rates of return, and only look at assets as a source of rate of return. While an asset value consideration can be a meaningful component of the overall valuation of an agricultural equipment dealership, it is the income generated by these assets that typically drives the value of a business. For this reason, the asset-based approach is typically not the sole (or even primary) indicator of value.

THE MARKET APPROACH

The market approach utilizes market data from comparable public companies or transactions of similar companies in developing an indication of value. In many ways, this approach goes straight to the heart of value: a company is worth what someone is willing to pay for it.

In many industries, there are ample comparable public companies that can be relied on to provide meaningful market-based indications of value. For equipment and machinery dealers, such options are relatively limited. Acquisition data from industry acquisitions (typically a median from a group of transactions) can be utilized as a multiple on the subject company's performance measure(s). This will often provide a meaningful indication of value as it typically takes into account industry factors (or at least the market participants' perception of these factors) far more directly than the asset-based approach or income-based approach.

The market-based approach is not a perfect method by any means. For example, industry transaction data may not provide for a direct consideration of specific company characteristics. Say a dealership operates in a prime geographic market with leading market share. Since the market and the specific company are relatively more attractive than the average transaction, the appropriate pricing multiple for this company is likely above any median taken from a group of industry transactions. Clearly, the more comparable the transactions are, the more meaningful the indication of value will be. Finally, caution must be exercised when utilizing data from market transactions since you never know all the circumstances surrounding each sale.

THE INCOME APPROACH

The income approach can be applied in several different ways. Generally, such an approach is applied through the development of an ongoing earnings or cash flow figure and the application of a multiple to those earnings based on market returns. The income approach allows for the consideration of characteristics specific to the subject business, such as its level of risk and its growth prospects relative to the market. This approach takes into account the specific market and business factors that will impact an dealership's business in the future.



SYNTHESIS OF VALUATION APPROACHES

A proper valuation will factor, to varying degrees, the indications of value developed utilizing the three approaches outlined. A valuation, however, is much more than the calculations that result in the final answer. It is the underlying analysis of a business and its unique characteristics that provide relevance and credibility to these calculations. This is why industry “rules-of-thumb” (be they some multiple of revenue or earnings, or other) are dangerous to rely on in any meaningful transaction. Such “rules-of-thumb” fail to consider the specific characteristics of the business and, as such, often fail to deliver insightful indications of value. An equipment dealer executing or planning a transition of ownership can enhance confidence in the decisions being made only through reliance on a complete and accurate valuation of the business.

CONCLUSION

Mercer Capital has long promoted the concept of managing your business as if it were being prepared to sell. In this fashion you promote the efficiencies, goals and disciplines that will maximize your value. Despite attempts to homogenize value through the use of simplistic rules of thumb, our experience is that each valuation is truly unique given the purpose for the valuation and the circumstances of the business.

Mercer Capital has experience valuing businesses in the agricultural equipment and machinery industry. We hope this information, which admittedly only scratches the surface, helps you better shop for business valuation services and understand valuation mechanics.

We encourage you to extend your business planning dialogue to include valuation, because sooner or later, a valuation is going to happen. Proactive planning and valuation services can alleviate the potential for a negative surprise that could complicate an already stressful time in your personal and business life.

For more information or to discuss a valuation or transaction issue in confidence, do not hesitate to contact us at 901.685.2120.

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