Mergers & Acquisitions Master Class Education Series

Valuation

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BARNES DENNIG
Accounting • Tax • Business Insight

E-TAP
Prepare and acquire a small business

Premise for a Merger or Acquisition

- Premise for M&A transaction: increase shareholder value
- Increased enterprise value net of debt, increased market value of equity
- Several alternative methodologies for valuation exist
  - DCF
  - Multiples
  - Completed transactions method
- Ultimately, “value” is a function of expected cash flows, now or future

Valuation Approaches

- Comparable Company Ratio Approach – multiple of:
  - EBITDA
  - Revenue
  - Net income
- Dividend Growth Model
  - Assumes constant cash flows
  - Next year cash flow divided by discount rate
  - "Quick and dirty"
- Discounted Cash Flow Valuation
  - Projected future cash flows discounted to present at Weighted Average Cost of Capital (WACC)
  - Enables calculation of value per share for comparison to pre-transaction value to measure value creation

Comparable Company Ratio Approach

Valuation Overview

Public Company Comparables

$ in millions

Company	Ticker	Market Cap.	Enterprise Value	Price / Basic EPS	EV / Revenue	EV/LTM EBITDA	EV/2010E EBITDA
Quanta Services Inc.	PWR	$4,264	$3,864	27.6x	1.1x	10.2x	8.1x
EMCOR Group Inc.	EME	1,482	1,165	8.2x	0.2x	3.1x	6.2x
MasTec, Inc.	MTZ	720	973	9.4x	0.6x	7.4x	5.4x
Dycom Industries Inc.	DY	454	485	NM	0.4x	4.3x	4.0x
Pike Electric Corporation	PIKE	369	484	10.8x	0.8x	4.7x	5.7x
MYR Group, Inc.	MYRG	400	386	19.8x	0.6x	8.0x	7.3x
Integrated Electrical Services, Inc.	IESC	124	93	NM	0.1x	5.3x	NA
			High	27.6x	1.1x	10.2x	8.1x
			Mean	15.2x	0.5x	6.1x	6.1x
			Median	10.8x	0.6x	5.3x	6.0x
			Low	8.2x	0.1x	3.1x	4.0x

$ in millions

Company	Stock Price	% 52-week high	Market Cap.	Net Debt	EV	LTM Revenue	LTM EBITDA	2010E EBITDA	LTM EBITDA %
Quanta Services Inc.	$21.50	64.0%	$4,264	($400)	$3,864	$3,527	$378	$477	10.7%
EMCOR Group Inc.	22.49	62.4%	1,482	(316)	1,165	6,218	379	188	6.1%
MasTec, Inc.	9.51	62.6%	720	253	973	1,542	131	181	8.5%
Dycom Industries Inc.	11.63	65.0%	454	32	485	1,107	114	122	10.3%
Pike Electric Corporation	11.04	57.5%	360	115	484	623	104	85	16.7%
MYR Group, Inc.	20.25	86.2%	400	(14)	386	628	48	53	7.6%
Integrated Electrical Services, Inc.	8.05	36.7%	124	(31)	93	725	18	NM	2.4%

Market data as of 9/1/09.
Source: CapitalIQ.

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Discounted Cash Flow Valuation

- Calculation of projected cash flows, discounted back at the weighted average cost of capital (WACC) of the combined firm
- How to:
  - Prepare a “pro forma” for the next 5 years (minimum) under the assumed deal structure
  - Calculate expected cash flows from such pro forma
  - Calculate Weighted Average Cost of Capital (WACC)
  - Discount expected cash flows including terminal value back to time zero (date of transaction)
  - The result is the estimated value of the firm

Weighted Average Cost of Capital

- Basic Formula

  WACC = (cost of equity * % equity) + (cost of debt * % debt) * (1 – tax rate)

  Cost of Equity = risk free rate + (beta * (exp return on market – risk free rate)) + size premium ?

    Risk-free rate = 10-year treasury bond
    Expected return on market = public expectations for yield on all public equity securities
    Size premium – published statistics for completed deals at different sizes (Ibbotson)
    Beta – published figure: levered vs unlevered

Weighted Average Cost of Capital (cont.)

- Cost of debt (similar for cost of preferred equity)
  - Interest on senior and sub debt
  - Yield to maturity on bonds
- Tax rate on new company applied to cost of debt, to reflect cost net of tax shield

Common Pitfalls

- Poor peer group selection
- Use of book values instead of market values for debt and equity
- Poor “pro forma” preparation
- Unrealistic growth rates