ADDING VALUE BY GOING PUBLIC ON NASDAQ

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The buying and selling of businesses is nearly as old as business itself; there were business brokers in Imperial Rome, and the contracts for the sale of a local gladiatorial school still exists. Buying and selling is an accepted fact of today's world, but in the last decade of our millennium, we are making a concerted effort to return to basics; in business, that means getting a bang for a buck, and the bigger the bang, the better. The world has rarely been more conscious of value than it is now.

With the increasing sophistication of the securities industry, stricter regulations, and the risk of litigation, everyone must protect himself. Therefore, it has become essential rather than merely desirable to obtain a Valuation Report before entering into many transactions, which may include tax reorganisations, divorce, transfers to children, and, of course, death. Another major reason for a valuation is a company Going Public, either through an Initial Public Offering, or through a Reverse Takeover, both of which can be used by a company to have its shares traded on NASDAQ.

NASDAQ has been around since 1971, but publicly traded companies have existed for much longer. In 1621, some Dutch merchants created The New Netherland Company, to settle what's now New York. Although they were shrewd business men, I have my doubts that they were thinking of NASDAQ then.

Rather earlier, the British had established The East India Company and The Muscovy Company, while the Dutch also had set up an East India Company. Of lasting influence concerning our own country, The Hudson's Bay Company was founded in 1670, and in 1821 absorbed its main competitor, the North West Company of Montreal; actually, this may be regarded as Canada's first leveraged buyout. Until the establishment of the corporation, which, thanks to a state charter, has an infinite life, the usual vehicle for operating a business was a partnership, or a limited partnership; these were short lived, as they terminated on the death of a partner.

Transfers of shares in a Swedish mining concern called Stora Koppenberg, or White Coppermountain, are recorded as far back as 1250, but shares of their successor corporation are still actively traded today.

Once the corporation existed as an organisational structure, separating management from ownership, the creation of a market to trade shares became important. According to Ferdinand Braudel, trading in Government Bonds existed in Florence before 1328, and speculation through short sales was common even earlier. Such transactions were sporadic, until in 1608, merchants in Amsterdam established The New Exchange for trading Government Bonds, Shares in the Dutch East India Company, Bills of Exchange (the ancestors of today's Bankers' Acceptances), as well as commodities, such as wheat or herring, for future delivery.

In its day, The New Exchange in Amsterdam was the greatest financial market in the world; it is the great great great granddaddy of today's well established securities markets, of which NASDAQ, with its wide range of electronically linked market makers, represents a high-tech successor, poised for the twenty first century.

Stock market prices do not of themselves represent Fair Market Value, which is defined as "the highest price available in an open and unrestricted market, between knowledgeable, informed and prudent parties, acting at arm's length and under no compulsion to deal, expressed in terms of cash"; however, subject to bubble rises and crashes, these prices are a helpful tool in valuations.
Canadians are aware of the excesses of speculation that have occurred from time to time, both on Stock Exchanges and in real estate markets. Recently, we saw something similar, when an Ottawa high-tech company, with sales of about $16 million and a loss of $900,000 in the last twelve months, could go public on NASDAQ at a price that represented a total market capitalization (issued shares times offering price) of US $66 million, or 5.5 times revenue.

Any management would be foolish to reject such an IPO, if a US investment banker is prepared to underwrite it on this basis. All I can say to that is "nice work if you can get it", even though this offering price is far above any value determined by normal investment criteria.

Excluding speculative bubbles, a stock market, especially NASDAQ, can still be relied upon to give a good indication of transaction value, as it reflects the opinions of thousands of investors in a regulated, active, liquid market. In comparison, markets for private companies are rather inefficient, as buyers are probably interested only if they can acquire control. Therefore, private companies have always tended to sell at lower multiples of earnings, or have higher Capitalization Rates than public companies.

Several studies concerning private transactions versus Initial Public Offerings prices have been done by two organizations, Robert W. Baird & Company, a large regional investment banking firm in Milwaukee, and Willamett Management Associates of Portland, Oregon, a prominent business valuation firm. The Baird study covered varying eighteen month periods between 1980 and 1990; the results showed that private transactions were at an average discount of 51% to the public offering price. The Willamett studies, which took place earlier than the Baird studies, averaged discounts of about 68%.

That means that on the basis of the Baird studies, a company is worth about 75% more after Going Public than as a private company; according to Willamett, this difference is approximately three times more value.

The stocks of hi-tech companies are especially successful after Going Public; for instance, Apple became worth four times as much as a public company as when it was private; the value of two companies in military computer systems increased by about seven times. However, there are some exceptions, as for instance companies in the Cable TV business, where the value changes hardly at all; not only is it a glamorous and active market, but every transaction in that field requires government approval.

As a business owner, you may be wondering about Going Public as a way to establish and increase the value of your business, on which you spent years of hard work. You've heard pro's and con's, and while not everything is within your control, when Going Public you should keep in mind the old Boy Scout Slogan: Be Prepared.

You can do much to influence the process and the eventual outcome, but you have to do your homework, and you must have the appropriate help to achieve the desired profitable results. One essential member of your team is an independent valuator, someone who has the skills and experience to realistically value your company's assets, capabilities, prospects and risks in relation to other companies with similar talents, in similar situations.

Here are the three absolute basics to keep in mind to increase the value of your company by Going Public on NASDAQ:

First, in most cases, Going Public on NASDAQ is preferable to undertaking the same exercise in Toronto, Vancouver, or anywhere else in Canada. In general, you get a higher multiple, exposure to a wider audience, greater diversity of interested brokerage houses, a larger number of market makers, and, perhaps most importantly, more available funds.

Being traded on NASDAQ gets you known in the States and leads to write-ups in widely read business publications. Especially in view of Free Trade and NAFTA, having their shares traded in the United States will be an increasingly important tool for the growth of Canadian companies, and should be of considerable help to be well received in that vast market. Besides, I have long harboured the conviction that the Yankee entrepreneurial spirit far exceeds that of us Canucks, so why not take advantage of it?

Second, make your company look good. We are constantly bombarded by ads telling us how we can look better and become more desirable; there are books on how to be more lovable, and deep down most of us do want to be liked; otherwise, why would Dale Carnegie have been such a success?

Exactly the same is true for a company. You want your company to be at its best when you are Going Public, and your Financial Statements to give the most favourable interpretation of the facts, reflecting increasing, or at least stable profits.

All this is part of the homework you must begin as early as possible before Going Public. You may have to streamline your business and cut out losing operations, which are a drag on your profits. You cannot afford sentimentality, and the fact that your father started the business in a drafty old garage does not mean you've got to cherish that old heap of rotting plywood; I bet dad would be the first to get rid of it. Keeping the old laboratory around may have made sense in the case of Thomas Alva Edison, who after all filed over a thousand patents from that location, and who was such an inspiration to Henry Ford that he transplanted it lock, stock and tree to Detroit; let's face it, not too many of our own ancestors are quite in that league.

Hanging on to the fabulous equipment for producing hula hoops that's rusting away in the back of the plant is not farsighted, because if they ever do come back, you will discover you'll need new machinery to compete with the stuff originating in the Far East, at a fraction of your cost.

Of course, that is a very simplistic example, but you have to be ruthless with yourself, and let go of ideas and hopes you have cherished for years. Dreams can be defended to a brother, or to a couple of partners who might grudgingly acquiesce, but you must not give the appearance of a dreamer to that hardnosed incoming board of directors. Again, an independent valuator, if he's any good and has your interests at heart, will point these things out to you, in varying degrees of harshness. He may even tell you to replace workers with up to date machinery, because if your company is not competitive, it will not survive, and all remaining employees will go down with you.

"Nothing can have value without being an object of utility. If it be useless, the labour contained in it is useless, cannot be reckoned as labour, and cannot therefore create value". That wasn't one of those hardnosed directors talking; it was written over a hundred years ago by Karl Marx in his aptly named publication Das Kapital; I have always believed you can learn from anyone, including The Enemy, but as an experienced valuator, even I am wondering how I would approach valuing enterprises resulting from the single-minded application of his ideology ....

I would have found it much easier dealing with The Muscovy Company, an English trading company given a charter in 1554, which granted it a monopoly of trade between England and Russia; it survived even Ivan the Terrible, and lasted nearly a hundred years.

Third, increase your price/earnings ratio by reducing your risks. Price/earnings ratios in general reflect the current economic conditions, such as interest rates, inflation and the growth in GDP as well as the specific factors affecting returns an investor will achieve from purchasing the company's shares, and the risks involved.

Management can do nothing about the external factors, and usually very little about the future rate of growth; where action can be taken is to reduce the risks in the business. I will talk more about that later, but first I would like to discuss

Who should Go Public?

Subject to the NASDAQ qualification standards, the answer is practically any company that can achieve an above average return on the new capital raised as a result of going public. Over the thirty plus years I have been a valuator, my firms have helped a great variety of companies along that route; among them were esoteric businesses specialising in intellectual property, such as: nuclear medicine, whose implicit value increased by several hundred percent after its major shareholder went public, photovoltaics, and lots of software, all of which at least doubled, and one increased four times.

However, we also gentled a farm machinery manufacturer into Going Public, with a subsequent doubling in value, and a grain burning stoves company, which increased only by 15%; a recently valued plastic bags manufacturer should also do well, although the process is not yet completed.

To Go Public on NASDAQ or anywhere else, you have to have management with a broad range of skills; for instance, being a fabulous cheesemaker isn't enough; you must demonstrate that you have people who know how to wrangle government quotas, find markets for the product, arrange distribution, keep a sharp eye on expenses etc. All this will be scrutinised by the underwriters; their view of management will add or detract from your appeal, and thereby influence the issue price of your shares. Generally, a one-man, or rather a one-person company isn't perceived to be such a good bet for Going Public, but then, looking at Ross Perot, there are no hard and fast rules.

In such a situation, it may be easier to Go Public through a reverse takeover; this means you roll your business into an already listed NASDAQ company as a shell in a share exchange. A number of well-established organizations used this route, such as Ted Rogers, Hees, and International SemiTech. Again, a valuation of the business to be acquired by the shell is a must, but this is another chapter altogether and too long for today; I'd be pleased to give you more information if you talk to me about specific details.

There are a number of benefits from Going Public, especially on NASDAQ. There is of course the increased value mentioned earlier. The process also gives you access to additional capital without having to share control, as you would have to if a partner came in.

Banks today are not very enthusiastic about lending to individuals to enable them to buy into a business, but generally, numerous investors will not need to borrow the few thou or so they intend to risk, and financial institutions are always looking for well performing, smaller companies on which they can get a higher return than on their mortgage portfolios.

Going Public also offers owners the possibility to diversify their investment and obtain additional liquidity; some of the funds received may be used to purchase bonds or stock of other companies, thereby adding security.

Often there is a "right moment" for taking the plunge, a natural window, when the company goes through its shiniest period, and when suitors are easily found; this very much holds true in the high-tech field, where products quickly come and go. Success of course is one of the best reasons for Going Public, but there are others. There will be increased public awareness of your company, especially if you Go Public on NASDAQ; such an event is usually accompanied by articles in national business publications, including details about the company, its history, expectations etc.

Personally, I suspect that hopes for such welcome PR was one of the reasons why Daimler Benz recently went public on the New York Stock Exchange, even though it led to a touch of humiliation; the Mercedes accountants were sent back to do more homework, so as to satisfy the requirements of US accounting standards, which are much more exacting than those practiced in Germany.

While our standards are as rigorous as those in the States, there are subtle differences between US and Canadian accounting practices, so it helps if a company's advisors are familiar with accounting and valuation in both countries. Within the past two years, I had the opportunity to apply my experience to valuations in the US, the UK and Switzerland as well as in Canada.

By the way, let me add here that just like Caesar's wife, a valuator must not only be independent, but must also be seen to be independent, although I seem to recall that independence was not really the issue with Calpurnia... A valuator is not permitted to have any direct or indirect interest in the shares of the company he is valuing; he is not allowed to accept all or part of his fee in profit participation, nor can his remuneration be in any way contingent on the deal.

Of course, only a fool would believe that Going Public is all milk and honey; some disadvantages may even cause a minor culture shock in privately held companies, which usually believe in secrecy. You will have to disclose a lot of information about your firm, such as management salaries, the principal shareholders, cost of sales, profit margins, etc.; all this information must be published in the prospectus, and, regularly thereafter, in your annual reports.

Another aspect of independence: a private company will find it easy to resist pressure for strong short-term performance, if making a substantial investment that may diminish immediate profits, will increase them in the long run. In public companies, especially in those actively traded, share prices will often show a decline along with the profits after such an investment, even though the value of the company and long term profits may actually be enhanced by the transaction.

The process of Going Public can frequently take Management away from the business of running the company for anywhere between three and six months. There is something you should bear in mind: as Lola sang in Damn Yankees, "give in"; give in to your accountant; give in to your lawyer; give in to your valuator, and hand over all the documents they ask for, and WHEN they ask for them. A good valuator knows what he needs and hands you a list at the beginning of the job; this will cut down on wasted time and the resulting annoyance for all concerned. While a professional valuator usually agrees to a maximum fee, it is subject to unforeseen circumstances; therefore, delays in receiving documents will not only be frustrating, but also costly.

Talking about costs: the initial process of Going Public is expensive; it requires an independent auditor who has to go over audited statements of the last five fiscal years, or from the inception of the company, and two sets of lawyers, one for the company, the other for the underwriters.

You also have to consider fairly substantial printing bills, first, with the preliminary prospectus, then the final prospectus, which is given to every purchaser of shares when the registration statement has become effective. Usually this is also sent to most security analysts, so you are looking at up to 15,000 copies, not to forget the cost of pretty stock certificates.

My advice is don't try to save on printing by letting your nephew do it, who is a real whiz with his desk top publishing gadgets in the garden shed; there are certain requirements, and stock exchanges prefer tradition to innovation in such matters.

The costs continue after you have Gone Public; you have to pay NASDAQ to be listed; you pay a bank or trust company to be the transfer agent, keeping track of the issued shares; you will have greater legal fees, as you must have lawyers vet all documents filed with the SEC. In the US, you also have to send quarterly statements to each shareholder; in Canada, this is required only twice a year, but both countries stipulate annual reports, and they can also run into money.

However, there is light at the end of the tunnel, and it's SOME KLIEG light. There is considerable impact on the value of a company by Going Public, not only while you own your company, but also if you decide to sell. As I said before, public companies are more easily marketable, their basic information and history are freely available, and the risk of surprises is much lower.

Something else to consider are the determinants of the share price. More has been written about those than about nearly any other subject, except perhaps for the Bible and the works of Shakespeare or Doyle. It is now reasonably accepted that investors are interested in the future returns on the shares from higher earnings, and the risks they perceive as being incurred to achieve those earnings.

The impact of return and risk applies not only to the issue price of the Initial Public Offering, but also to the share price as it will be traded on NASDAQ for years to come. Again, in order to avoid surprises, get yourself a good valuator, and you will know where you stand, both as to the current operations, and to the realities of your future plans.

For many industries, including nearly all high-tech companies, the value placed on the present situation is less than the portion of the value attributable to events that are expected to occur in the next five to ten years.

One simple and generally used method of valuing companies is by capitalising the Earnings Per Share, which are obtained by dividing the Net Income, less preferred dividends, by the average number of common shares outstanding. The Capitalization Rate used will reflect current interest rates, an equity premium, the specific risks relating to the company, and the expected rate of growth in Earnings Per Share.

In my view, the two most important factors behind the rapid rise in the prices of "small cap" stocks over the last two years have been the decline in long term interest rates, and a reduction in relative perceived risks. Investors now recognize that risks in smaller companies are in many cases no greater than those of the giants that traditionally dominated conservative investment; in the US, a small cap stock is one with a total market value of less than $100 million.

For your company's stock price to rise, you have to either reduce interest rates, earn greater profits, increase their future growth rate, or lower the perceived risks. The first four are very difficult to do; therefore, an integral part of planning to Go Public on NASDAQ or on any other stock market is to reduce the perceived risks. This will have the effect of increasing the price/earnings ratio and therefore lowering the cost of capital.

The potential risk areas that can be reduced are: strategy; management; capitalization; product range; customer or supplier dependence; the regulatory situation; technology in use; and profit margins.

Strategy

This can be an underrated contributor to either risk or stability; during the 1980s, many organisations diversified, acquiring companies in unrelated businesses with different operating cycles, so as to ensure a regular increase in earnings per share. While diversification makes sense in a threatened industry, such as cigarette production, there seemed little rationale for a tobacco company to go into shipping, unless they were subconsciously thinking about a smoky version of rum running.......

While other acquisitions may not be quite as bizarre, no organization has the skills to be a successful Jack of all trades; the stock market has reacted to conglomerates by adding a premium to the Capitalization Rate, thereby lowering the price/earnings ratio in comparison to that of a portfolio of "pure plays". The reaction ultimately has been for some of those conglomerates to undergo restructuring by spinning off, or "demerging" operations that were discovered not to fit; this in turn restored value.

Companies adopting other high risk strategies to increase value by accelerating the growth in Earnings Per Share may also suffer a fall in the price/earnings ratio, as a risk premium is applied to their Capitalization Rate.

Management

Going public means that you must appoint a Board of Directors, which can bring new blood into a complacent bureaucratic situation; sometimes this means they'll make tabula rasa. In turn, it is absolutely essential that the board makes certain the management team has experience in the industry, understands the technology and is skilled in all the elements, such as finance, marketing, sales, production, R & D etc., that make up the business. If the Board of Director earns its keep, there will be possibly uncomfortable probing questions, but also enthusiasm and useful suggestions.

Capitalization

For many centuries, being free of debt was considered a virtue. However, with the present low interest rates and high corporate taxes on public companies, adding a moderate amount of debt and using it to pay a special dividend to the owners before Going Public may lead to an increase in the total value.

After "The Big Event", profits will have declined only minimally, and the value will not be much different to when the company had no debt; however, you will have the proceeds of the dividend in your pocket. You've made money, and your company will look almost the same.

Product Range

Some months ago I was told by a furious lady that on that day the only bras in the Bay's lingerie department were size 34 B, and they had racks and racks of them; she bought nothing. If you have only one product, you have a risk; if you try to make too many products, especially if they are unrelated, you run a different risk. A business wants to have a well-established, interlocking line, or series of lines.

It is a management truism that 80% of the profit comes from 20% of the products. Reducing the 80% of unprofitable products can be an important part of the streamlining for Going Public. When I valued a food conglomerate some years ago, it turned out that one international brand of instant coffee produced 135% of the profit; nearly all the other hundred or so products lost money.

If you own a shoe factory in Oakville and a pickle maker in Concord, consider disposing of one of them; not only will you lack the skills to run both of them well, but the complexity will confuse shareholders and be reflected in the reception of your stock. Besides, I firmly believe that profit decreases with the square of the time it takes you to get there.

Customer/Supplier Dependence

In two recent unrelated valuations, single product clients had relied on a sole supplier who went into bankruptcy. One lost a whole year's sales for his seasonal product, the other had his half-finished machine sold for scrap by the sheriff. Another client made millions serving a major customer, which eventually took 80% of sales; when the customer cut back, the company collapsed and went into voluntary receivership; I valued the remains.

Therefore, even with an ironclad contract, you should never be dependent on one supplier or one customer. The rule of thumb is that if one customer represents more than 20% of your sales, or if over 20% of your purchases come from one supplier, you may have trouble. Such details must be disclosed in the valuation and in the prospectus. As the valuation should come first, there is time to reconsider this dependence and seek to arrange a change.

Regulatory Situation

About six months after the end of World War I, William Lyon Mackenzie King said: "Labour can do nothing without capital, capital nothing without labour, and neither labour or capital can do anything without the guiding genius of management; and management, however wise its genius may be, can do nothing without the privileges the community affords".

In return for these privileges, business is subject to regulation. Numerous Federal, Provincial and State Laws and Regulations affect all businesses, including antitrust regulations, local practices, product liability and warranty requirements. All those as well as political connections, the presence of the military-industrial complex, and even the dirty word "lobbying" may influence the value of a company. A good valuation, which always includes thorough research, can be of great help in identifying the applicable pitfalls and smooth the planning process. I recall with, I hope, forgivable pride the number of occasions on which astounded clients in various fields told me that they had discovered things about their industry they had not known before, after reading my draft Valuation Report; it was of considerable assistance to them in the long run.

Environmental Impact

To be concerned about the environment is not only good for one's conscience, it has also become fashionable to be a good citizen. Merely being perceived as a polluter may be detrimental to the acceptance of a company's products and thereby to its success. Contrary to accepted belief, protection of the environment does not always automatically imply greatly increased costs, job losses, or losses in general.

A few years ago, the CEO of a well-known, large and respectable food company used a small plane to reach a remote Quebec location; flying low over a severely damaged forest horrified him, and spurned him to great vigilance within his own company. In spite of adding equipment to protect the environment, the company's profits have increased; I believe this is such an emotional, prejudice riddled topic that I intend to write about it in the near future. Again, a good valuator gives you good research.

Technology in Use

There is one simple absolute: if your technology is behind that of your competitors, you likely won't last, but it will not be profitably. You may muddle through, perhaps cutting down here and there and make the old truck last another year, but that is not a long-term solution. Outmoded equipment will not allow you to achieve the required degree of accuracy, lead to errors and cause missed deadlines.

Well programmed, up-to-date information systems are a key to successful manufacturing, wholesale, retail and distribution operations. You must know what sells and what doesn't just remember the racks of size 34 B bras... In short, up to date technology and knowhow are among the most important aspects of a company underwriters look at.

Generally, the more technology restricts entry to a field and the fewer competitors you have, the higher the company will tend to be rated. Prime examples are fine chemicals, pharmaceuticals, portions of the electronics industry, and everything that has strong patent protection.

You also have to be smart as to where your company puts its funds; one company we recently valued spent a great deal of money buying the building instead of investing in modern machinery, and we all know what happened to real estate values. Customers hang around because of the personal goodwill created by the owner, but the business is only marginally profitable and could not successfully Go Public.

Profit Margins

All businesses have fixed and variable costs. High fixed costs give great operational leverage when things go well, but mean that profit margins can decline rapidly with any decrease in volume. A reasonable balance between fixed and variable costs, combined with good profit margins, means you face fewer risks and will not suffer severely from losses, even if sales go down, while costs continue their annual upward progression.

Of course, this may not always be realistic; if you have a unique product, it will always fetch a good price, and even deliver nicely cushioned profit margins; if you produce hula hoops, you better make sure you remain competitive with the new tigers from the East and can recoup profit margins in different product lines. All this will be closely scrutinised by investors.

Whether you want to Go Public or not, a Valuation can be of considerable value to your company for other reasons; in the printed text you will find a complete list of services we offer, and of course, I'd be pleased to talk to you about your individual needs and aspirations. As a matter of fact, the first session with a valuator is usually free; although not quite like a visit to the dentist or being interviewed by Mike Wallace, it may also be somewhat disconcerting. As I said before, chose an experienced valuator, even ask him to give you references you may call, and then trust him. To paraphrase Voltaire, if you see your valuator jump out a window, you should probably follow him, because good value would likely be at the bottom.

A very good lawyer I know, and with whom I have collaborated on a number of companies Going Public, confessed to me in a moment of truth that at least 10% of her job is holding the client's hand. There is much wisdom in that, as Going Public isn't something one does every day. Of course, that is yet one more reason to deal with seasoned professionals, so that you will achieve your goal with as little pain as possible.

I am not sure who said it, but it must have been a somewhat hedonistic sage: "There are two things to aim at in life, first, to get what you want, and after that, enjoy it; only the wisest of mankind achieve the second". We would like to assist you in determining what you want, and help you along the way to get it.