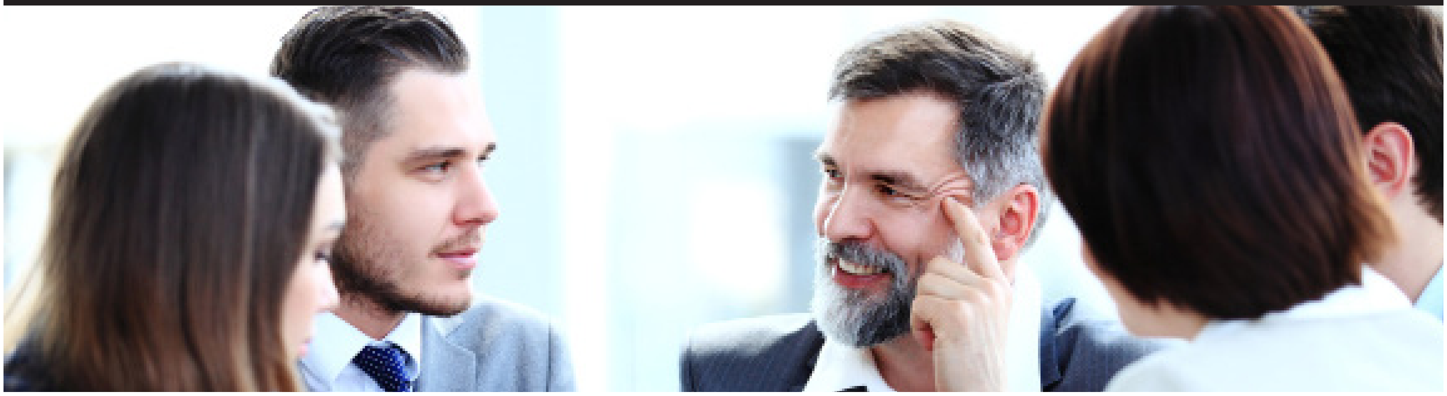
Florida Capital Advisors
BUSINESS ADVISORS

Advice and Capital for Shareholder Buy-Outs and Real Estate Transactions



Understanding Value Creation in a Privately Held Company

Let's start with the basic premise of value creation: Value is created when the return on equity exceeds the cost of equity.

The cost of equity to a company is the investor's expected return on investment for providing capital to a business. This return on investment is compensation for bearing the risk associated with ownership in the equity of a company. The cost of equity to particular company can have a wide range. For a large, publicly traded company, the cost of equity is generally between 8% and 15%. For a middle market privately held company, the cost of equity can be between 25% and 35%. The cost of equity can be much higher for a small business. This higher cost of equity for private companies is to compensate an investor for the additional risk that goes along with a less developed company, as well as the lack of liquidity in the investment. Generally speaking, as the owner of a privately held company, if you are not generating a return on equity in excess of 25% you are not creating value. To the extent the situation persists year after year the company will have little to no value.

An investor's expected return can also be translated into a multiple of earnings by taking the reciprocal of the expected return. For example, an investor with a 25% expected return would pay a four times multiple on earnings i.e. (1/.25=4). The level of risk in a company (which is expressed as a discount rate) is the primary driver of the cost of equity. A lower risk company will have a lower cost of equity or to say it another way, investors will have a lower expected return due to less risk. So by lowering your company's risk profile, while maintaining earnings, you will create value.

Want to create another $1 million in value? Let's assume you have a company generating $1 million in earnings annually. If you lower your company's risk profile and therefore the investor's expected return from 25% to 20%, you will move the multiple from 4x to 5x earnings (1/.25=4x vs. 1/.2=5x).

Earnings and the risk profile of the business factor into valuation. To get a premium valuation when it's time to sell your company must be viewed by potential buyers as providing the desired return on investment. It's too late six months to a year before you want to sell to take the steps necessary to maximize value. A long planning horizon and a disciplined approach with the right advisors and bankers are critical to success.

Chuck Owston, CMAA, CEPA
Managing Director
407.540.5802
cowston@flcb.com

Peter Allport, CEPA
Director
407.540.5806
pallport@flcb.com