Jim Hitchner's
Valuation Products and Services

DO YOU KNOW?

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A free periodical to promote education and alert you to important areas of interest in the financial valuation, fraud, and litigation services profession.

Do you know...

...that there are business valuation "dirty little secrets" out there?

Jim Hitchner will discuss 20 business valuation dirty little secrets in his ***upcoming webinar on July 16th****. One of the secrets is the misuse of the so-called "optimal" capital structure.*

First and foremost, what is the so-called "optimal" capital structure?

"An optimal capital structure is the objectively best mix of debt, preferred stock, and common stock that maximizes a company's market value while minimizing its cost of capital."

"In theory, debt financing offers the lowest cost of capital due to its tax deductibility. However, too much debt increases the financial risk to shareholders and the return on equity that they require. Thus, companies have to find the optimal point at which the marginal benefit of debt equals the marginal cost." - Investopedia Optimal Capital Structure

"The optimal capital structure of a firm is often defined as the proportion of debt and equity that result in the lowest weighted average cost of capital (WACC) for the firm. This technical definition is not always used in practice, and firms often have a strategic or philosophical view of what the structure should be." - Corporate Finance Institute

Many valuation analysts (analysts) rely on the capital structures of public companies to select the so-called optimal capital structure for the valuation of a private subject company. This is an easy exercise, correct? Maybe not. Potential areas of concern are as follows:

1. Is the capital structure driven by acquisition debt vs. operating debt?
2. Is the capital structure driven by purchases of capital expenditures or stock buybacks?
3. Does the debt have equity kickers?
4. How are stock options handled?
5. To unlever and relever betas, what is the proper tax rate to use?
6. Is there really an optimal capital structure?

The first five items are an important part of due diligence and will discussed during the upcoming webinar. The last factor is addressed here. Let's take a look at a selection of actual guideline public companies. All the companies are in the same or similar industry.

Guideline Public Companies	Levered Beta	Interest-Bearing Debt	Debt as a % of Invested Capital
The Eastern Co.	0.33	35,225	17.7%
P & F Industries, Inc.	0.42	2,022	6.3%
The L.S. Starrett Co.	1.28	22,312	27.0%
Twin Disc, Inc.	1.73	4,684	1.5%
Visteon Corp.	0.79	19,650	9.2%
		Mean	**12.3%**
		Median	**9.2%**

The range of debt as a percentage of invested capital is 1.5% to 27.0%. This is a pretty wide range. So, what do analysts do? They take averages, usually the mean and/or median. The mean is 12.3% and the median is 9.2%. So, we're done, right? Not so fast. L.S. Starrett's debt percentage is three times that of the median. Twin Disc has a debt percentage that is 16% of the median. Of the five public companies, only two, Visteon and P&F Industries, are close to the median.

The subject private company being valued had no debt as of the valuation date. The reason is that the owners do not like debt. They said they wanted to sleep at night knowing they were not beholden to any banks. This is not an unusual situation with small- to medium-size private companies. So, why isn't zero debt the optimal capital structure? I think it is a consideration since these companies should be included within the world of hypothetical sellers. Also, many buyers will apply acquisition leverage to the deal. However, this is seldom at an operational level of debt. Most buyers want to pay down a high amount of acquisition debt. The bottom line here and the dirty little secret may be that there is no "optimal" level of debt, at least on a practical vs. theoretical level.

For more information, **join Jim Hitchner on July 16th** as he presents his views on this dirty little secret as well as 19 more.

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