

What is Your Company Worth?

Business valuations are based on various metrics such as tangible book value, discounted future earnings, liquidation value or replacement value, or a multiple of earnings or cash flow. In practice, almost all valuations are based on some multiple of projected earnings or cash flow capitalized at a multiple to reflect the present value of what a buyer or investor is willing to pay given their targeted risk tolerance.

Valuing an early-stage company in a fast-growth industry presents its own set of problems. There may be no earnings record and not much of a sales record. Projecting earnings then discounting to the present helps, but how fast will revenues and profits really grow? In such instances, you have to study very carefully the growth prospects of the industry. This includes discussions with securities analysis, reading analyst reports regarding the market sector and industry (such as Gartner), and also discussions with potential or actual customers as to their expected demand for the product or service offerings. Based on this information, you can better support your assumptions used to forecast future growth and earnings potential.

A company's current EBITDA (earnings before income taxes, depreciation and amortization) is the starting point to estimate future cash flow and earnings. However, past performance does not always equal future results. To increase the credibility of projected earnings, there is a need to analyze a company's negotiating leverage in the marketplace over the competition, its suppliers, its customers and potential new entrants.

Three prominent variables in determining the value of a closely held business are (1) the type of future income to value, (2) the forecasted amount of this income and (3) the capitalization/discount rate utilized to convert this income into a current value. The primary type of income used for valuation purposes is EBITDA, adjusted for normalization or economic effects to show a more accurate presentation of economic earnings. Potential adjustments to "normalize" EBITDA include AR and inventory reserves, leases, market value compensation adjustments and contingencies.

The amount of income used depends on business, industry and market trends. Valuations reflect the future expectations of business earnings and cash flow. The amount of projected future earnings is based on historical results adjusted for future expectations. Future expectations will be influenced by actual company and market growth rates and trends for a time period prior to valuation, as well as published industry, market and general economic trends that are used to estimate future trends.

Capitalization/discount rates essentially reflect the rate of return a buyer or investor expects on its investment. The higher the risk premium associated with a company's projected future earnings, the higher the capitalization/discount rate an investor will use. Valuations go in the opposite direction of capitalization/discount rates. As capitalization/discount rates (risks) increase,

valuations decrease and vice versa. Investment risk is analyzed based on many factors that can impact future earnings and cash flows. These include a company's current financial strength (e.g. debt to equity ratio versus industry benchmarks), barriers to competition, management's ability and depth, profitability and stability of earnings and national and local economic effects.

Rules of thumb based on industry or market conditions can be a good starting point for a company to understand its valuation. However, studies have shown that, on average, businesses sell for one-third less than an accepted industry rule of thumb. A common rule of thumb is to use the P/E of a publicly traded company in the same industry. However, in practice, a privately held company will be sold for a discount of 25% to 40% to this P/E ratio. Also, such comparison to a public company is almost pointless unless the private company is at least 10% the size of the public company.

Benchmark multiples such as 3x to 5x times EBITDA are commonly discussed valuation targets. These multiples can be viewed as reflecting an investor's expected minimum rate of return assuming no growth in EBITDA after the purchase. For example, a 3x multiple reflects a 35% expected minimum rate of return (or capitalization/discount rate) on the investment, whereas a 5x multiple reflects a 15% target return (or capitalization/discount rate). Management applying these multiples to an existing business without first "normalizing" the earnings/EBITDA to reflect what the business may look like in the buyer's hands will prove misleading.

If there are plans to sell your company in the near future, valuations can be greatly improved by taking current steps to increase earnings and reduce the risk premium. These are typically changes that buyers/investors are likely to make to your business after the acquisition. Making these changes prior to the transaction will increase your company's valuation. Such steps include spinning off or selling under performing divisions or businesses and making personnel changes to improve business performance and increase earnings.

Some changes can be achieved easier than others. For example, a buyer may not want to retain members of the seller's executive management team. Elimination of these key employees prior to closing a transaction is usually not possible. However, if a seller forecasts these employees could be eliminated upon such a transaction, then they can increase their "normalized" future earnings used for their valuation.

Also, it is wise to have a track record of audited financial statements by a reputable CPA firm. If it is considered that an audit is too costly, then perform auditing procedures for areas of financial reporting that may be of high risk. Management should also address whether their internal controls would pass Sarbanes-Oxley compliance, and the potential impact noncompliance may have on valuation, especially if the buyer could be a publicly traded company.

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Structuring a sell of your company as an asset or stock sell will have different tax and legal implications to the seller as well as to the buyer, and each situation is unique and has to be carefully analyzed. A buyer will typically want to buy assets as they avoid any unknown liabilities that may arise in a stock purchase. Also, there are significant tax advantages for a buyer to structure the purchase as an asset sale as a large part of the purchase price will be recovered more quickly through immediate tax savings. From the seller's perspective, a stock sale may provide the best after-tax return. The structure of the sale should be considered in the price.

If you need assistance with valuation or selling your company, please contact Harvest CFO Consulting by telephone 724-934-4752, or e-mail dhillier@harvestcfo.com. Also, please visit our website at www.harvestcfo.com.

Harvest Your Corporate Value

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