

Valuing Private Companies - Some Key Considerations

Frankly, this is even more obtuse and frustrating a topic than “Capital Sources for Private Companies”, another of our White Papers which is available, but we’ll give it a shot!

You’ve probably heard lots of different theories on how to value a company, or that “it’s more of an art than a science”.

Truth is, valuation is more science than art--the art follows the science.

Valuation is about doing the appropriate research and analysis, about pulling the relevant data out of the marketplace and applying it to your situation appropriately – and most importantly, convincing the buyer that you have a logical and supportable methodology.

Dueling Methodologies

At the end of the day, well-advised buyers and sellers will come up with these methodologies and choose the one (or ones) that best support their goals – the highest value for the seller and the lowest value for the buyer.

This is where valuation intersects with deal strategy and execution. You have to try to create the situation where you have the leverage: If there is only one buyer at the table, and they know it--no surprise, the methodology will tend to favour the buyer. If you can create some real, or at least perceived, competition among buyers, the methodology will move toward favouring the seller. This is the art of the deal.

All this is fine and nice – but it still doesn’t get you any closer to knowing what your company is worth!

Valuation Methodologies Relevant to Private Companies

Some of the most commonly used methodologies are:

- Multiple of earnings, or profits.
- Multiple of EBITDA, or cashflow.
- Multiple of sales revenues.
- Value of most recent investment plus a “lift” based on actual milestones achieved since.
- Multiple of book value of net tangible assets.
- Discounted cashflows or “DCF” value.
- Public company trading multiples less private company (liquidity) and size, and possibly other, discounts.
- Industry-specific yardsticks.
 - For example, internet-based businesses have been at the extreme end of having their own vernacular when it comes to valuation--but not used much any more are multiples of employees, or even multiples of losses or cash burn (the notion was that these losses were actually investment in the future, creating future value, so, the bigger the better by definition – brave notions indeed).
 - Internet and more traditional business valuations have converged, and the remaining difference tends to be in the size of the multiple attributed to the same operating or fundamental characteristics, such as profits or cashflow. This is usual due to differences in growth potential.

At the end of the day, practically speaking, it all tends to come down to bottom-line profit growth potential. The greater the supportable and quantifiable growth potential, the more aggressive the ultimate valuation methodology generally, and the higher the multiple. It can make the difference between a 2-3x cashflow multiple to a 20-30x multiple!

How’s that for a non-committal answer to the question of what your company is worth!

For what it’s worth, a company’s value tends to be more robust, and the range narrower, when there is convergence between the various methodologies. When valuation is all over the map using different methodologies, it could be an issue with your business and its nature or stage, or it could be an issue with the party doing the valuation!

A company’s value also tends to be more tangible and easy to articulate when you can value it based on historical revenues, or profits or cashflow – and the more

years the better. Historical results and track record act as a platform on which to base a forward-looking valuation.

Factors in Valuation Multiples

Some of the most relevant factors include:

- The state of the overall economy.
- The state of your industry.
- The strength of the public stock markets.
- The amount of capital sloshing around the system looking for public and private investments.

All of these vary over time, rising and falling, with the attendant effect on valuation multiples. So valuations are not static based on the facts of the business alone, they are impacted by variables outside the company, and possibly completely unrelated to the company!

Some Definitions Used in Valuation

What we are talking about in this discussion is generally the Enterprise Value of a company, not its Equity Value.

Equity Value is the total worth of all the shareholders of a company. It can be enhanced, or hurt, by financial engineering such as loading up with debt.

Enterprise Value is the total of the Equity Value plus all interest-bearing Debt of the company. Enterprise Value ignores how a company is funded and structured – it refers to what the business itself is worth fundamentally. Generally no financial engineering in this figure!

Working Capital also plays a role in determining valuation. Often the sale price of a business is adjusted, upward or downward, to adjust for and provide the business with sufficient working capital for operations.

Other non-core, non-operating assets or liabilities are also often excluded in determining the value of the core business and treated as “redundant assets” in the determination of total value

So . . . What the Heck is My Business Worth?

The short answer is, there is no short answer! Again, it comes down to doing the analysis of your business and industry, and the current business environment, to bring all the variables to bear in your particular situation, and also incorporating the context of why you are even thinking about valuation, whether it is in selling your business, merging with another business, financing your business or making an acquisition.

To fail to do all this may make it easier to attach a value to your business--but also means more likely that it is a meaningless valuation you will never actually see in cold, hard cash.

To conclude, we leave you with two important thoughts on the topic of private company valuation:

First, always check very carefully the technical qualifications and relevant real-life experience of the advisors you choose to provide you with a valuation, or incorporate a valuation into selling your business or helping you buy a business. Make sure they are capable of doing the technical analysis we speak of above.

Second, is a thought we seem to always be harping on: If you see something that is just too easy or good to be true, chances are it is! There are always crazy examples of astounding valuations, but most commonly, you simply cannot defy gravity. An attainable valuation is all about good, solid analysis, understanding your business and industry, and staying true to the full facts of the situation.

We would be very pleased to discuss any of this further with you as you figure out your plans for the future.

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We hope this paper is helpful, but stress that it is for your general information only. We urge you to obtain proper professional advice, be it legal, tax or corporate finance, before making any decisions regarding your business.