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Mergers & Aquisitions,
Financing, Business Advisory Services

What is your business worth?

Much has been reported recently about the record number of privately-owned businesses expected to be sold in the coming decade as baby boomers decide to cash-in and take their retirement. While this is a topic of great interest for business owners, there is little factual information publicly available on business transactions and there are a lot of misconceptions as to how businesses are priced.

A general understanding of how businesses are priced by the financial markets is crucial to any business owner contemplating a sale. With a realistic valuation, the business owner can wait with confidence for the right offer.

There are four basic approaches to valuation which are: (i) multiple of earnings; (ii) book value (iii) discounted cash flow and (iv) industry comparables. Each of these methods have their particular strengths and, when calculated and considered all together, can provide a well balanced approach to pricing a business.

Multiple of Earnings Method

The multiple of earnings method is probably the most widely accepted approach on which actual private company transactions are negotiated and priced. More specifically, it is the enterprise value as a multiple of EBITDA.

Enterprise value is basically the value applied to the whole company as if it was purchased free of debt but including the assumption of trade payables. EBITDA is short for earnings before interest, taxes, depreciation and amortization. This method is popular because it is easier to compare one business to another as it eliminates the consideration of capital structure, interest expense, taxes and other non-cash items that are unique to each business. In essence, it represents the operating cashflow generated by the company (prior to reinvestment in capital expenditures, which we will discuss later).

The multiples of enterprise value to EBITDA currently reflected in the marketplace for traditional businesses in Canada range from 5X to 7X. Specific business considerations could cause this multiple to vary. In considering EBITDA, we are trying to determine the true earnings capability of the company, or normalized EBITDA. Normalized EBITDA may exclude certain nonrecurring items or excessive owner compensation. We must also look at the trend, stability and predictability of earnings. This becomes more of a challenge for companies experiencing recent high growth rates, companies experiencing losses or those with very volatile earnings over the previous 5 years. In general, the most recent earnings are given the most weight in determining the EBITDA to which the multiple is applied.

Since many transactions consist of share purchases, the value of the shareholders' equity must be derived from the enterprise value. The equity value would be calculated by taking the enterprise value and subtracting interest-bearing debt (i.e. normal operating bank debt, long term debt, equipment leases, etc.) net of any excess cash.

Let's consider the example presented below, for a company generating a normalized EBITDA of $4,000,000 per year. Using a multiple of 5X EBITDA, the enterprise value would be $20,000,000. From this amount, we would deduct the total debt of $4,000,000 to derive an equity value for the shares of $16,000,000.

Example (in thousands of $)

Balance sheet			
Accounts receivable	3,000	Bank debt	2,000
Inventory	4,000	Accounts payable	2,000
Prepaid	500	Long term debt	2,000
	7,500		
Fixed assets	4,500	Shareholders' equity	6,000
	12,000		12,000
Calculation			
EBITDA	4,000		
Multiple	5		
Enterprise value	20,000		
Less debt	(4,000)		
Equity value	16,000		

Book Value Method

Book value is another valuation method though it is rarely used alone as it does not necessarily reflect the ongoing profitability of the business. A company may have accumulated years of retained earnings and have a high book value but be currently losing money and gradually depleting book value. Book value is used more as a "reality check" to compare the purchase price of the shares (equity value) to the actual book value. Generally, the purchase price will not exceed book value by more than two or three times. A greater multiple indicates that a great deal of goodwill is being paid in excess of the actual asset value.

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What is your business worth? (cont'd)

In our example, the purchase price of $16,000,000 would be the equivalent of 2.7 times the book value and represent goodwill of $10,000,000 over the shareholders' equity of $6,000,000. For companies with low profitability, the derived equity value may sometimes be less than the actual book value. If we used the same example but instead of $4,000,000 the company was generating only $1,500,000 of normalized EBITDA, the enterprise value would be $7,500,000 and the equity value would be $3,500,000, a discount to book value of $2,500,000. This reflects the fact that although the company has net tangible assets of $6,000,000, they are not generating a sufficient economic return.

Discounted Cash Flow Method

The third method used in valuing business is the discounted cash flow method which forecasts the future operating cash flows of the business and takes into consideration annual reinvestment required to sustain or support the operating cash flows. This series of cash flows is then discounted to the present u sing an appropriate discount rate (or rate of return). While this method would seem to be a more precise manner in determining value, the challenge lies in substantiating the future cash flows (underlying assumptions, etc.) Unless the company has a large portion of business under contract or a track record of continued growth, the potential buyer will give less weight to future increases in profitability and tend to base the purchase price on the most current level of earnings, which brings us back to the EBITDA multiple approach. Indeed, a company with a solid track record of growth or able to substantiate future increased profitability with signed contracts, supply agreements, etc. will generally command a higher EBITDA multiple in any event.

Industry Comparables

The final method consists of looking at other transactions and associating the transaction prices with other measurements. The most basic comparable would be sales (e.g. one times sales, etc.) but, depending on the industry, could be related back to capacity, subscribers, installations, etc. Much like book value, industry comparables cannot be used alone to determine value but they are frequently used as a test of "reasonableness" of the calculated valuation when compared to other previous transactions in the same industry.

Other Considerations

While these valuation methods can provide a solid base for establishing a price, there are a number of factors which may serve to add to or reduce the calculated value. Factors which may serve to justify higher prices or multiples include: healthy gross margins, low cost manufacturing capabilities, a solid management team, long term contracts or agreements with customers and a solid reputation in the marketplace.

Factors which may reduce value include: a high percentage of business from a few large customers, concentration of decision-making with the owner-operator and a declining trend in gross margins and rising operating costs. In some cases, although the company may still be quite profitable, a downward trend or a serious threat by competitors may cause a lower than normal multiple.

In addition, the general assumption in deriving enterprise value is that the company has a normal level of required working capital. Therefore, excess cash or other redundant assets are typically excluded from the transaction. Conversely, in the case of insufficient working capital, the buyer may subtract the investment required to replenish working capital to normal levels.

Enterprise value also assumes a normal level of ongoing capital expenditures to maintain the company's operating assets. In the case of aged equipment where there has been little reinvestment in fixed assets, a lower multiple is justified since the buyer will not only have to pay the purchase price but also invest a surplus amount to update equipment and machinery.

Conclusion

Pricing businesses is more art than science. Just because a certain value is calculated using these methods does not make it so. We have to take into consideration the mergers & acquisitions marketplace. Ultimately, a business is worth what someone else is willing to pay. To the extent that there are a number of potential purchasers and there are strategic benefits for these purchasers, the vendor is in a stronger position. What the calculated value does provide is an objective and widely accepted basis for establishing a price range from where the buyer and seller can negotiate without having vastly different conceptions of what the business is worth. In other words, it brings reasonable buyers and sellers together and increases the chances of concluding a successful transaction.

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