Valuing Your Company

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A critical consideration for virtually every business seller is the value of their company. Unfortunately, determining the market clearing price for any business is not a science. While time-tested valuation methods can be applied to the financial metrics of every company, the prediction is not always completely reliable. Nevertheless, when sellers are evaluating their strategic alternatives, they need benchmarks to use in decision-making.

Strictly speaking, the value of anything is what the "market" is willing to pay for it. For a business the only way to determine the value for certain is to undertake a well designed sale process. The outcome will tell the owner precisely what his business is worth. However, the owner would like a good idea before undertaking the process. So what should he do?

The valuation methods used by financial advisors have not changed materially in the last several centuries. They typically include Discounted Cash Flow, Publicly Trading Comparables, and Public and Private Company Transaction Values, the last two dependent on financial metrics usually related to the income statement of the target. In valuation multiples, the order of preference is typically cash flow, net income, gross margin, revenue, book value, and invested capital. In the early days of fiber for telecom, companies were sold that had no revenue and were sold as a multiple of how much had been invested in the fiber network. However, buyers are ultimately interested in the amount of cash they will be able to take out of a company. The long run may never actually arrive so in the meantime he is focused on financial metrics that demonstrate the ability of a business to generate cash sometime in the future.

Each valuation method has pitfalls. For example, the DCF, arguably the right way to value anything, requires a lot of assumptions about the business and the market. You must make a forecast for a multi-year period. In fact, the right period is forever; however, the typical shortcut is five years, which is equally difficult to

do accurately. How can anyone know how a business will perform three years into the future? Most companies miss their one-year budgets, sometimes substantially. In addition, you must use the costs of debt and equity, which are applied to those future cash flow estimates. While there is some “science” to those calculations, there are also plenty of assumptions about capital structure, appropriate comparable companies, size adjustments, among other things that make those calculations approximations at best. On the other hand, transaction multiples are single numbers that explain very little about what the buyer is receiving for their money. In addition, for private company transactions this data is not publicly available and therefore unreliable. Nevertheless, these metrics are typically all that is available.

So where does that leave the business owner considering a sale of his company? At the end of the day he knows what cash his business puts in his pocket. He also knows what sum of money he would accept in exchange for his business. He may never get the value that he wants, but he should not undertake a sale process unless he is confident he wants to trade his expected future earnings for a sum he is relatively confident he can get.

One important consideration in estimating the value of a business are market conditions at the time of sale, in particular, the attitudes of both strategic and financial prospective buyers. While buyer sentiment has nothing to do with the performance of a business, it will impact the competitive dynamic that bears on the “multiple” paid for a company. Strategic buyers that want to grow aggressively or need additional scale to facilitate higher margins at a point in time will pay a higher price than they otherwise would. Financial buyers will bid more aggressively when interest rates are low or transaction activity has been particularly weak. When conditions are favorable, competition can lead to a value greater than the intrinsic value, the present value of the expected future cash flows.

The bottom line is that sellers should get comfortable that the timing of their sale process will allow them to meet their objectives, one of which is value. The ultimate valuation will depend on many factors, some of which are outside anyone’s control. Consequently, the seller should focus on a realistic minimum

value that they would find acceptable. Should they achieve a better valuation in the process, they will be pleased. If their minimum number is above realistic expectations, they may want to reconsider their decision to sell, at least at that particular time.