Understanding how to value your business

The value of your business will only ever be determined definitively by the market. A company is ultimately worth what a willing buyer or buyers are prepared to pay for it.

But understanding the textbook approach to valuation will equip you for the way price negotiations are likely to be framed. If you are still in the planning phase for an exit, you will also find that there are decisions you make today which will affect how those negotiations play out.

Valuing a company in advance of a sale is not an exact science, but it is possible to estimate the value of your company based on current market data and an assessment of your company against key valuation drivers such as:

- the company's historical and projected financial performance;
- the strength of its market position;
- the company's IP or other key differentiators; and
- the strength of its management team.

Methods of valuation

Although there are a number of methods used for valuing a company, the following two methodologies are the ones most frequently utilised by acquirers:

- multiple of normalised earnings; and
- discounted cash flows.

Multiple of normalised earnings

Under this valuation methodology, an appropriate multiple is applied to the normalised earnings of a company to convert those earnings into a capital value. Normalised earnings are a company's profits adjusted for any abnormal or non-recurring items.

Once the normalised earnings of the company have been determined, the appropriate multiple to apply to these earnings is determined by reference to:

- the earnings multiples on which comparable quoted companies are trading on the stock market; and
- the earnings multiples on which similar businesses in the company's sector have recently been sold.

On average, UK private companies are sold at a discount to quoted public company profit multiples, but the quantum of that discount will vary depending on a number of factors such as the growth profile, market share and size of the company. A discount is usual though because the quoted companies will typically be larger which makes them more robust in the eyes of the market.

Let us take, for example, the case of a travel business which made an operating profit of £2m before interest, tax, depreciation and amortisation ("EBITDA") for its last financial year. The owner took out salary and pension contributions of around £500,000 in excess of the "arm's length" level which would have been required to be paid to an external candidate for the CEO role. In addition, there was some £500,000 in costs which could properly be categorised as "one-offs" which would not recur under the ownership of a purchaser. These included costs involved in fighting a substantial piece of litigation, an exceptional loss on the sale of a property owned by the company, and a one-off significant bad debt. Accordingly, the company's normalised operating profits for its last financial year were £3m.

An analysis of recent transactions in the company's sector reveals that a competitor of a similar size and growth profile had been sold recently for an historical multiple of EBITDA of 8 times. This comparable transaction would support an enterprise value (or cash free/debt free valuation) for the company in the region of £24m. However, the company has a term loan of £2m and a fully utilised invoice discounting facility of a further £2m.

A purchaser will always deduct any borrowings from its valuation of your company in determining the price payable for the shares. Accordingly, £4m (assuming the company has no surplus cash) needs to be deducted from the £24m enterprise value to obtain what is called an equity value (i.e. the price you will receive for your shares) of approximately £20m.

Earnings before interest and tax (EBIT)	£2m
Add backs to profit	£1m
Adjusted EBIT	£3m
X 8	£24m
Less borrowings	£4m
Equity value	£20m

Historical earnings have been used in this example for the sake of simplicity, but in reality, when your business is growing, you want the purchaser to value your business on the basis of your current year earnings or, better still, your profit run rate based on your last few months trading. A purchaser may well agree to this if he believes your current growth is sustainable.

Buyers are typically more comfortable rationalising a higher price with reference to higher adjusted profits. So in the run up to a sale it pays to consider decisions like expensing or capitalising IT spend which will affect EBITDA as well as the one off adjustments described earlier.

Discounted cash flow ('DCF') methodology

The discounted cash flow methodology values a business by discounting the projected future cash flows which your company will generate to ascertain their present value. From the perspective of a private equity house, these cash flows will comprise any running yield/dividends or capital repayments it receives during the life of the investment plus the "exit value" of its investment, being the proceeds of an ultimate sale or flotation.

Private equity houses have a target level of returns they need on any equity investment they make. This target level of return will be a combination of the money multiple (the number of £s the investment will return for every £ they invest) and the internal rate of return or "IRR" (the annual return the investment generates). From their perspective, the maximum price they will be prepared to pay for a company is the price which results in the PE firm achieving its hurdle rate of return.

At this price, the value of its initial investment will be exactly matched by the positive cash flows it expects to generate from the investment, discounted by its minimum IRR.

Care should always be taken with any DCF valuation methodology as the resultant valuation is heavily dependent on the company's financial projections. Even small changes to the discount rate and the assumptions on which the projected cash flows are based can have a material effect on the valuation.

As with all valuations reliant on projections, the result is only as good as the quality of the assumptions which are made.

Other valuation methodologies

Profits or cash flows are not always the main determinants of a company's value. There are certain sectors, such as software-as-a-service ("SAAS"), where multiples of Annual Recurring Revenue represent the predominant valuation methodology. In this instance, during the pre-sale period, the shareholders should therefore seek to maximise ARR at the expense of profits such as by investing in their sales and BD teams.

Fund management companies are often valued as a percentage of funds under management, while for companies involved in property investment, net asset value is the primary determinant of value. There are several other industries in which other specific valuation methodologies apply – your adviser will be able to tell you if your business falls within them.

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Woman of Influence series

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