Alamo Corporate Group Inc.

Independent Services for Business Buyers & Sellers

VALUING PRIVATELY-HELD COMPANIES

Introduction

Valuing companies may be more of an art than a science, but there are three basic factors that acquirers evaluate when trying to establish a price for a business.

- **Quality of Earnings** -- Acquirers will look at the earnings to see if the numbers include a lot of "add-backs" or one-time events (like a sale of real estate which does not reflect on the true earning power of the company's operations). It is not unusual for companies to have "some" non-recurring expenses every year, whether it is a new roof on the building, a hefty lawsuit, write-down of inventory, etc. An acquirer will be wary of financials that restructure the earnings without "any" allowances for extraordinary items.
- **Sustainability of Earnings Following Acquisition** -- The key question acquirers often ask is whether they are acquiring a company at the apex of its business cycle or whether the earnings will continue to grow at the previous rate.
- **Verification of Information** -- The concern for the acquirer is whether the information is accurate, timely and relatively unbiased. Has the company allowed for possible product returns or allowed for uncollectable receivables? Is the seller above-board or are there skeletons in the closet?

The multiple of earnings varies according to many aspects including the company's history, the industry, the market, management, potential, proprietary products or services, niche, growth rate and size. The multiple also depends on the buyer's desired rate of return, e.g., a 5 multiple represents a 20% ROI while a 4 multiple represents a 25% ROI. The higher the perceived risk, the higher the desired ROI. For companies over $50 million in sales, the multiples averaged 6.5 times EBIT while companies with less than $10 million in sales averaged a 4.5 multiple. Based on using the same EBIT of $1 million for one company with $50 million in sales versus another company with $10 million in sales, the difference in price is equivalent to 44% more for the larger company.

Measuring Earnings

When a seller talks about earnings, one has to really define earnings, e.g., EBIT or EBITDA; 2014 earnings or 2015 projected earnings; EBITDA - CAP X; reinstated without prerequisites but with add-backs, etc. Sometimes intermediaries will submit a selling memorandum and the earnings will be recast including all the owner's (CEO) salary and compensation – Wow!

When an acquirer is analyzing earnings, he or she will want to know, is it for one year, three years, interim earnings annualized, combination of reporting periods, projections, etc.? What is the time frame for measuring earnings and what is the trend of earnings?

Another concern in measuring earnings in the future is what changes might affect earnings such as an increase in rent, family members off the payroll, loss of key customers and/or vendors, etc.? Beware of companies that are locked into long-term contracts in which they are unable to raise prices or companies in a commodity- type business in which there is unrealistic market pricing.

Key Considerations

The following questions are useful in understanding a business and valuing a company more prudently:

- What's for sale? What's not for sale? Does it include real estate? Is some of the equipment leased instead of owned?
- What assets are not earning money? Perhaps these assets should be sold off.
- What is proprietary? Consider formulations, patents, software, etc.
- What is the company's competitive advantage? Is it a certain niche, superior marketing or better manufacturing?
- What is the barrier of entry? Is it capital, low labor, tight relationships?
- What about employment agreements/non-competes? Has the seller failed to secure these agreements from key employees?
- How does one grow the business? Maybe it can't be grown.
- How much working capital does one need to run the business?
- What is the depth of management and how dependent is the business on the owner/manager?
- How is the financial reporting undertaken and recorded and how does management adjust the business accordingly?

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Check List for Valuation

1. *Start with the Business.*
    - Value Drivers:
        - Size, growth rate, management, niche, history
    - Value Detractors:
        - Customer concentration
        - Poor financials
        - -Outdated M&E
        - Few assets
        - Lack of agreements with employees, customers, suppliers
        - Poor exit possibilities
        - Small market
        - Potential technology changes
        - Product or service very price sensitive
2. *Financial Analysis:*
    - Market Value – comparables
    - Multiple of Earnings - based on rate of return desired
3. *Structure and Terms:*
    - 100% cash at closing could reduce price 20%
4. *Second Opinion:*
    - Even professionals need a sounding board.
5. *Indications of High Value:*
    - High sustainable cash flow
    - Expected industry growth
    - Good market share
    - Competitive advantage - location/exclusive product line
    - Undervalued assets - land/equipment
    - Healthy working capital
    - Low failure rate in industry
    - Modern well-kept plant
6. *Indications of Low Value:*
    - Poor outlook for industry
        - foreign competition
        - price cutting
        - regulations
        - taxes
        - material costs
    - Distressed circumstances
    - History of problems
        - employees, customers, suppliers, litigation
    - Heavy debt load

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Conclusion

The above information is helpful in determining what multiple of earnings or what discounted cash flow rate to incorporate; however, it doesn't determine the actual number. Much of the information above will influence the person's perception of value. Valuation is often in the eyes of the beholder, regardless of whether the price is rational.

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