

VALUING & SELLING A BUSINESS

by Howard Leigh

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info@SOGiants.com

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INTRODUCTION

Selling a business should be one of the most financially rewarding events in the career of any entrepreneur. With a quick calculation on the back of an envelope it is enough to see why. The value of most businesses is calculated as a multiple of annual profit, so a successful sale can be the equivalent of the reward for several years' work, taken in one fell swoop. What is more, in many countries capital gains are taxed at a lower rate than income, further increasing the value of the deal to the vendor. And, of course, once the business is sold, the entrepreneur is free to set up a new enterprise and, perhaps, repeat the whole process all over again.

However, selling a business is also a complex, time-consuming and often emotional experience. From the start of the exercise to the moment the cash from the sale goes into the bank typically takes around six to nine months. In this period, a large number of elements need to come together:

- Valuing the business
- Timing the sale
- Finding the right buyer
- Negotiating price and terms
- The due diligence process
- The closure and conclusion of the transaction

And it needs to be remembered that all of this comes on top of the stresses of the day-to-day running of the business itself, which has to continue to perform well.

Picking a way through this minefield and achieving a successful outcome requires excellent planning, a lot of hard work, and probably, a large slice of good fortune too. But good advice is also crucial.

Selling a business is not something business people do very often so the first piece of advice is to bring in someone who is a specialist in this area. An expert who's familiar with the process should add value and make the whole experience far less painful. A good corporate financial advisor can also carry out negotiations with third parties and should be able to find competitive offers that will push the initial price up. If the business has experienced non-executive directors there can be a role for them here in terms of working with the external advisors and helping to manage the process, thus taking some of the strain off the CEO and CFO.

That said, both the CEO and the CFO will have to be heavily involved and this article is designed to give an overview of what is involved in selling a business and practical advice for every stage. This is covered in the Section I of the article. Key take-outs are given at the end of each section.

In Section II there is an overview of the most common ways of valuing a business. An understanding of the different ways a business can be valued helps the vendor to get the most out of their advisors but it must be stressed that this is only an overview and the 'devil is in the detail'.

SECTION I

SELLING A BUSINESS

1.1 Is the business saleable?

The first thing the financial advisor should be able to determine is – is the business saleable? A sale may not be possible for a number of reasons. For example:

- The business may be over-dependent on the owner or on a single customer or supplier
- The business model may be fatally flawed, it may have been profitable in the past but this is unlikely to continue
- The company may operate in an industry which is in terminal decline

There may also be situations in which a sale is viable but the likely valuation would be so low that it would not be in the proprietor's interests to sell it. Even when a sale might be an appropriate exit route, it may not be the optimal time to sell. The company's growth profile, the current size of the business, market conditions and a host of other factors may dictate that a sale should be deferred.

At some stage in the selling process the motivation for the sale will inevitably be raised by potential purchasers. Why is this business for sale? Why now? It is best to be clear about this at the outset and as open and straightforward as possible. The principle shareholders must have discussed and agreed this to the point that there is total consistency. Businesses are sold all of the time, for a variety of valid reasons:

- The Owner(s) do not have the energy or ambition to take the business to the next stage
- They may have other ambitions – including retirement – that now take precedence over running the business

- They may always have had it in mind that they would sell the business when it had reached a certain point
- There may be personal reasons (ill health) for the sale
- It may be that there is honest disagreement about the future direction of the business that they cannot resolve, and they have therefore decided to sell
- They may simply feel that the potential of the business can be better realized by new owners and now is the time to sell

There are many other valid reasons for selling and if at all possible they should be made apparent in a matter of fact way. What should be avoided is any suspicion that the business is being sold because its best days are behind it! If the real and valid reasons are made clear then there is less danger of this.

It may be that the process of agreeing the motivation for selling actually uncovers the fact that the owner(s) do not really want to sell at all. Once a business is sold, it is sold. You may have the money in the bank but you have lost 'your baby'. This needs to be addressed right upfront. Once the process gets underway it inevitably gathers a momentum of its own it can be very hard to stop if there is a change of heart.

Of course the answer may be that the owner (s) do want to sell under certain circumstances i.e. that the price and terms are right and they are happy with the consequences for the business. In which case set these out clearly.

KEY TAKE-OUTS

1. Start by using expert help to establish that the business is saleable and this is the best timing.
2. Be clear and straightforward about the motivation for selling.
3. Be sure that you really, really want to sell the business and what the criteria for sale are.

1.2 Grooming the business

Assuming that the business, the motivation and criteria for selling, do not fall at any of these hurdles, the next thing to do is to groom the business to enhance its attractiveness and value to potential purchasers.

Ideally this should happen a considerable time – even two or three years – before the sale exercise starts.

Strategic decisions can be taken that don't affect profit and loss or cash flow but do maximize the value of a business to a purchaser. For example, certain purchasers might be unhappy about a company using agents when it could be using distributors instead. Some purchasers might not like the franchise model and so buying out franchisees might be considered. Protecting the brand name in overseas locations is something that is often overlooked but might also be very important to a potential purchaser.

As most businesses are valued as a multiple of profit, ways of improving short-term profitability must also be considered. Often, a company's pricing policy is designed to keep prices sufficiently low to deter potential entrants while maximizing profits over the longer term. However, prices might be increased in the lead-up to the sale to boost margins and improve the company's bottom line. At the same time, a review of costs should be undertaken to identify and eliminate all proprietorial costs that would not be incurred by an incoming purchaser. These might include relatives of the proprietor on the payroll or excessive travel and entertainment costs.

When a business has assets that may not be required or fully valued by a purchaser, such as surplus property or investments, removal before a sale exercise commences should be considered. Also, in the lead up to a sale, working capital should be reduced to the minimum level required to run the business. Although the owner should take advice as to the tax consequences of any of these moves.

The quality of the company's management team will generally be of paramount importance to a purchaser, especially if the owner/manager(s) are proposing to leave the business at the time of, or shortly after, a sale. So it is important to be able to demonstrate to the purchaser that there is a competent second tier of management available to assume executive control of the business following the sale.

There might also be ways of increasing the multiple that the purchaser will apply to the business's profits in the valuation. This might be done by repositioning the business in a different area. For example, in one case a printing company was able to achieve a higher multiple by positioning

itself as a marketing company and highlighting the design aspect of its work. In another case, a fashion company was similarly successful by emphasizing the logistics side of its operation.

Having said this, it is important not to be over-zealous in the grooming process or to boost profits in artificial ways which will be exposed during due diligence. This will backfire on the vendor and may destroy a relationship of trust established between the vendor and the purchaser.

KEY TAKE-OUTS

1. Grooming the business for sale should start well ahead, ideally a few years ahead of the actual sale.
2. There are many ways of improving short term profitability (pricing, cutting unnecessary costs, cash flow, asset sales, succession planning, positioning).
3. These must be sensible and defensible to a potential purchaser or they will backfire.

1.3 Identifying potential purchasers

The most common trigger for the sale of a business is the receipt of an unsolicited offer. Sometimes people are flattered by this and seduced into progressing the offer without properly considering the other available options. The best response to such an offer is to park it and then find other purchasers who can beat it. So who might these potential purchasers be? In identifying potential purchasers, it is important to think laterally; it is often the less obvious buyer who will be prepared to pay a premium price for the business.

Many vendors believe that the optimal purchaser will be someone based overseas. They imagine that an offshore buyer is more likely to pay a large premium as well as protecting their employees and their brand. Although it can be quite difficult to find such a buyer for a small to medium-sized business there is an organization called "M & A International Inc" that may be able to help. This is an international alliance of 40 firms operating in 37 countries that tries to identify buyers in particular industries and sectors and can certainly serve to increase the vendors' options and support the price.

In the home market, the best type of buyer is probably not somebody in your own sector, but somebody who is already in your industry and is looking to enter your sector. For example, a fish manufacturing business was sold recently. It took raw salmon, turned it into pate and distributed it to supermarkets. The owner of the business thought that the best buyer would be someone in the fish sector, but in fact people in the meat sector were prepared to pay a higher premium because for them the acquisition represented a way to grow and diversify while still using their existing technology, distribution and customer base.

There might also be interest from the private equity community, although activity here has abated since the start of the economic downturn. However, they are still interested in acquisitions, particularly if the company has the capacity to take on debt.

Management Buy-Ins have been becoming less and less popular, particularly in the current climate. They are undoubtedly the highest risk and institutions have wised up to the fact that management going in cold to a business will come across problems and issues they hadn't anticipated; the wily entrepreneur who's selling the business will certainly know things that make it hard for incoming management to pick up the reins. However, Management Buy-Outs – in which a company's own management buys the business at a premium price – are still deemed to be very attractive. But it can be tough negotiating against your own people and there is always the worry about what will happen if the negotiation turns sour and how the business will survive if that happens.

When identifying potential purchasers, start off with a full list including possibilities in different sectors and countries. Then reduce this list to a manageable number by dividing them into an 'A' list and a 'B' list containing names to be held in reserve. Finally, a highly targeted and confidential approach to 20 or 30 of the most likely buyers within a short period of time should, in most cases, generate an optimal outcome. A scattergun approach smacks of desperation and will deter certain buyers, who may feel they have a relatively low chance of securing the acquisition.

KEY TAKE-OUTS

1. Be thorough and comprehensive in identifying all potential buyers.
2. Think laterally – including outside your industry.
3. Be strategic in honing this list down– select the best and organize them into an 'A' list and a reserve list.

1.4 The information memorandum

A key part of the approach to potential purchasers is the information memorandum. This document enables them to decide whether or not the company is a suitable acquisition target. Although the information memorandum needs to be accurate, it is essentially a selling tool, and one that is key to generating interest in the vendor's business.

Presentation is therefore as important as the substance and the memorandum needs to reflect the style of the organization being sold.

One thing to consider is writing different information memoranda for different buyers. Most companies prepare just one information memorandum, photocopy it and then send it out to all potential purchasers. However, this may not always be the best tactic. Unless the company is subject to Stock Exchange and Takeover Panel rules, different information can be sent to different buyers and information can also be restricted from certain buyers. The reason for doing this, of course, is to position the business in such a way as to appeal to each individual buyer and to encourage them to acquire it for a premium.

It's also important to think hard about the best time to make an approach to different potential purchasers. It's not necessary to approach everybody at the same time. It's a good idea to first contact the people who will take the longest to consider the opportunity – these may be purchasers outside the industry or those who are based overseas. People who know the business best should be approached last because they won't need as much time to decide whether or not they want to make the acquisition.

KEY TAKE-OUTS

1. The information memorandum is a selling tool – presentation not just the content is important.
2. In certain circumstances you are able to target different versions to different buyers.
3. Think about who to approach first.

1.5 Confidentiality

Proprietors of private companies are generally concerned about the negative impact that a leak of an impending sale would have on staff, customers and suppliers. These concerns are often justified, as competitors who become aware of an impending sale, will exploit the uncertainty surrounding the future ownership to reach key staff or customers.

However, the only way to proceed is not to worry about whether there will be a leak, but to assume there will be one.

If you work on this basis, you will be ready to manage the leak when it happens. The golden rules are not to tell your employees or customers anything untruthful and not to be surprised or put on the back foot, but to come up with something that explains the corporate activity which is taking place.

You might want to have a smoke screen prepared that all the advisors and inside team have signed up to. This might be along the following lines:

"We often receive approaches and we always consider them carefully, but at the moment we're not in any detailed negotiations and there are no immediate plans to sell the business."

Alternatively it may be possible to deflect attention by talking about fundraising or a change of bank that would explain the sudden flurry of corporate activity.

As the process unfolds, many proprietors are also concerned about when to inform their staff and colleagues. Although some senior people may be told about the plans at a fairly early stage, it is almost certainly best to restrict the sharing of information to a 'need to know' basis.

KEY TAKE-OUTS

1. Confidentiality is a concern – work on a need to know basis.
2. However, assume there will be a leak and be prepared.
3. Have your response (or cover story) worked out and ready.

1.6 The sale process

Choosing the right sale process is essential for a vendor intent on maximising value. Getting the process wrong can have dire consequences for valuation and may even condemn the sale to failure. There is no 'one size fits all' sale process but the two most commonly used are formal and informal auctions

FORMAL AUCTION

In a formal auction, potential bidders are set a timetable requiring them to give the vendor an indicative valuation by a certain date on the basis of information contained in the information memorandum. Following receipt of indicative offers, several potential purchasers are short listed and given the opportunity to meet management, conduct site visits and are given access to a data room, which will typically include a vendor due diligence report. Thereafter, they will be required to make a final binding offer for the company, which will usually include the purchaser's 'mark-up', where the vendor prepares the purchase and sale agreement and invites the purchaser, or his lawyer, to comment on this ('mark' it up). This serves to highlight any contentious issues which need to be considered at the time of receiving the purchaser's binding offer of a share purchase agreement drafted by the vendor's lawyers and included in the data room.

INFORMAL AUCTION

However, when selling a small or mid-market business it is usually better to conduct an informal or 'soft' auction. In this case, potential purchasers are not given a hard date by which they must respond. Instead, the vendor tries to understand what the potential purchasers have to go through – in terms of internal committees, fund raising exercises, due diligence and so on – and then shapes the sales process accordingly.

To get the best deal a vendor must understand what a buyer particularly likes about the business for sale. This enables the vendor to negotiate from a position of strength and to push the price.

It is also a good idea for the vendor to get the price he is hoping to achieve on the table fairly early on, so that purchasers are not working under false pretences and don't expect the business to be sold cheaply. (See Section II for methods of valuation)

Indeed, it is extremely important to avoid a low price bid coming in at an early stage, as this may act as a base point in future negotiations.

Throughout the sale process the vendor needs to remember that, however hard it may seem, they can actually walk away at any time if their objectives are not met. If, for example, the target

price is no longer there, the vendor should think long and hard about why the sale is progressing. They need to have the mental stamina to be able to say that under certain conditions they will not sell the business. And, for that reason, at the back of their mind they need to have fallback options if the sale should fail – such as refinancing or bringing in new management.

KEY TAKE-OUTS

1. The selling process can be a formal or informal auction.
2. Informal is best as it allows each potential buyer to be treated individually.
3. Get the target price on the table early.
4. Be prepared to walk away but have a back up plan if the sale falls through.

1.7 Heads of agreement

Once all offers for the business have been tabled, the next step is to negotiate the terms of those offers. Assuming, at the end of this process, one or more of the offers is acceptable, it is then necessary to choose the offer which best meets the objectives of the vendor.

It is customary for the essential terms of that offer to be enshrined in heads of agreement. Although this is not usually a legally binding document, (apart from the provisions relating to exclusivity, costs and confidentiality), it should cover all of the important elements of the deal. No matter how tempting it may be, it is unwise to defer important issues for subsequent discussion for several reasons:

- Firstly, the heads of agreement stage is usually a honeymoon period where good relations exist between the vendor and the purchaser. The relationship will often deteriorate once the due diligence process starts and legal negotiations commence.
- Secondly, the vendor's negotiating position is at its strongest at this stage as, hopefully, they will have a number of competing offers on the table to which they can revert if they cannot get the concessions they are seeking from the preferred bidder. If a vendor is forced to revert to other bidders after negotiations have been terminated with the preferred bidder, at the very least their negotiating position will have been seriously impaired. At worst, they may find that the interest of other buyers has dissipated, as they have moved on to other things.

Typically, the heads of agreement document will be somewhere between three to ten pages long and it is generally not advisable for lawyers to get too actively involved in drafting it, as this can considerably lengthen the process and result in a loss of momentum and enthusiasm on the part of the buyer. Having said that, it is important for a lawyer to cast his eye over the heads of agreement before they are finalized, as it is difficult to negotiate away from a position entrenched in the heads of agreement or to introduce new elements after the heads have been signed.

KEY TAKE-OUTS

1. The Heads of Agreement should be succinct but must include all the important elements of the deal.
2. It is at this stage the vendors negotiating power is strongest – get it right to avoid the deal failing and to set yourself up for the due diligence stage.
3. Have it checked but NOT drafted by lawyers.

1.8 Due diligence & warranties

Due diligence is, in essence, an investigation of the business and its market and designed to ensure that the assumptions underlying the purchaser's offer are correct.

Vendors often fear the due diligence process, but provided the vendor has not withheld any crucial information, it should not give rise to any unpleasant surprises.

Under the terms of the share purchase agreement, the vendor will also be required to give warranties regarding the business that they are selling. In so doing, the vendor is essentially confirming that what they have told the purchaser regarding the business is accurate.

Accordingly, alongside due diligence, seeking warranties from the vendor is a means by which the purchaser can help to ensure that they are buying what they think they are buying. The warranties and indemnities 'ensure' the buyer gets exactly what he sees and that he is protected from any nasty surprises through the appropriate recourse. A warranty claim will arise if the statements of fact about the business confirmed by the vendor are subsequently proven to be inaccurate.

Some vendors get extremely agitated about the prospect of having to give warranties to the purchaser. But in reality, the number of occasions when a claim is made for a breach of a warranty is comparatively small. Certainly, purchasers should not expect any guarantees in respect of future performance. If they do, it should be resisted. However, they will expect the business to be in the state in which it's been described to them and, if the vendors have been honest and forthright in their dealings with a purchaser, they will generally have little to worry about. After all, they know their businesses extremely well. It's worth bearing in mind that, if they do quibble over warranties, it sends a signal to the sellers that there may be problems and that can have a price impact.

The extent of warranty cover sought by a purchaser is a consideration in reviewing competing bids, as there will inevitably be some matters covered by the warranties which are outside the vendor's direct knowledge or control and so expose them to some degree of unquantifiable risk.

If there are any concerns about warranties, it may be a good idea to conduct all email traffic relating to the sale on a private computer, independent of the main company system. If the normal work computer is used, it may happen that after the transaction a shrewd purchaser will decide to go into the server and undelete all the emails that the vendor thought they had deleted and so find out things that he didn't want them to know. If, however, a private computer is used, at the end of the transaction it can simply be unplugged and taken out of the building.

KEY TAKE-OUTS

1. If the vendor has been honest and straightforward during negotiations there is nothing to worry about in Due Diligence.
2. There will be warranties – a kind of purchaser's insurance policy against surprises post sale – but these should not include future performance.
3. How onerous the warranties are can be a reason to favour one purchaser over another (or a reason for the deal to break down).
4. Internal emails about warranties relating to sale should be stored on a private computer.

1.9 The consideration

When it comes to the consideration, most sellers look for a cash payment for 100% of the business up front. However, there are some sectors, such as Marketing, where buyers won't agree to this and in some cases this may not be in the seller's interest anyway. Sometimes, after a number of meetings with different types of purchaser, vendors take a view that the opportunity to earn a greater amount over time is more attractive than cash on day one. Alternatively, if they believe that the purchaser will enhance the value of the business they might prefer to take a percentage of the cash consideration as 'paper' (share equity) in the purchasing entity.

Where the consideration is split between an up front payment, (the initial consideration), and a balance payable over time (the deferred payment), dependent upon some measure of future performance, then this is referred to as an 'Earn Out'. There are many ways to structure an Earn Out, and variables include the stages at which shares are bought and sold, the nature of the consideration, and the formula used to determine each future payment to be made. Given these complexities and a tendency for buyers to involve themselves in their new acquisitions at an early opportunity, and, through this, unwittingly affecting the agreed Earn Out formula, many Earn Outs are never concluded – with buyer and seller agreeing to an earlier buy-out.

So in certain sectors and under certain circumstances vendors will take some of the consideration in share equity payable over time, dependent on certain key events. These might be based on profit or turnover after the acquisition, or there might be a formula that is a function of both together with other key milestones. There are several complicated types of payment structure for sellers but they all boil down to much the same thing: paying over time or paying dependant on performance.

TAX IMPLICATIONS

A number of schemes that claim to minimize taxation are currently being touted around, but the climate is becoming increasingly unfavourable for such schemes and it is very unlikely that they will work. Certainly in the UK, the received wisdom is that it's best to plan on paying the 18% Capital Gains Tax and then moving on. The alternative is to emigrate for a period of time, in which case tax in the UK can be avoided, but you have to be careful that you're not moving into a jurisdiction where there's an equally high rate of tax or where your residency allows them to tax your worldwide income. It's also possible to postpone tax by taking loan notes of the equivalent consideration, where the tax will be levied at some point in the future. However, if you take a view that capital gains tax can only go up then this is not a clever move.

Your external advisor and your accountants should offer advice in this area.

KEY TAKE-OUTS

1. Ideally the offer, the consideration, should be 100% cash upfront.
2. Dependant on sector and other circumstances it may be better for the vendor if the offer is paid over time, dependant on performance and/or paid in 'paper' in the purchaser's business.
3. Specialist advice should be taken about tax implications.

1.10 Towards exchange & completion

A lot of people think that signing the heads of agreement means that the deal is done. Unfortunately, it often means that the hard work is only just beginning. The big problem is usually that buyers start to look for reasons to chip away at the offer price. In doing this, they are often unwittingly assisted by management who come under increasing pressure as completion approaches and, as a result, take their eye off the ball. This affects trading performance and this gives an excuse to lower the offer.

For this reason, a shrewd vendor will have kept something up his sleeve to counter any negative move on the part of a purchaser.

This might be some good news about a new order that has been won, or a new contract that has been successfully negotiated or a new employee who has just been signed. It's always a good idea not to put everything into the heads of agreement, but to keep something back for any difficult moments that might arise.

The vendor will also need to manage the lawyers carefully during this phase. The problem for lawyers is that they can't communicate directly with the principal on the other side but can only talk to their lawyers. So, if there is a moment when the principal on the other side needs to be contacted directly, the vendor needs to be prepared to over-ride their lawyer and assume responsibility for doing so themselves.

Lawyers are an essential part of the selling process and for the most part can be relied on to be professional and experienced. However, they have a tendency, (they would say a professional duty), to be very pedantic and very comprehensive in identifying all possible negative scenarios. The vendor has to get involved in this detail and has to be prepared on occasions 'to take a view' on what is strictly legally necessary. Again, the external advisors can help enormously here and, as noted already, there may be times when the vendor and the purchaser need to be able to communicate directly and with common sense.

KEY TAKE-OUTS

1. There is a great deal of work to be done after the Heads of Agreement have been signed.
2. The management team must not take their eye off the ball i.e. keep the business trading strongly.
3. Keep something up your sleeve for any adverse events that may allow the purchaser to chip away at the offer price.
4. Manage the layers carefully and keep lines of communication with the purchaser open.

1.11 Conclusion

Each business is unique, and each vendor has their own characteristics and objectives. The key take-outs have been highlighted – use them as a check-list throughout the selling process. However, certain key rules nearly always apply in achieving a successful sale:

1. Determine your objectives and ascertain whether a sale process would achieve them.
2. Start preparing for a sale exercise well in advance and get advisors on board early.
3. Take steps to properly groom and position the business for sale to maximize value.
4. Choose the correct sale process for your business.
5. Never underestimate the significant resource required to conduct an exercise and ensure that the performance of the business does not suffer in consequence.
6. Be prepared to walk away from the deal if your objectives are not being met.

Will this ensure that as a vendor you get the price you want? How much is your business worth and typically how will the potential purchasers determine this? In the next section the most common methods for valuing a business are outlined.

SECTION II

VALUING A BUSINESS

2.1 Introduction to Methods of Valuation

There are a number of theoretical and accounting methods that can be used to value a business but, at the end of the day, the value is what someone else is prepared to pay for it. It must also be remembered that, while the vendor may have an idea of what the business is worth, may use this in negotiations and indeed may decide to walk away if it is not reached, the most important thing is what the purchasers calculates the value to be to them. They decide what the business is worth and the vendor decides whether this is acceptable. So do we need to bother with methods of valuation?

We do, for two obvious reasons:

- By understanding and using, as appropriate, different ways of valuing the business the vendor can have a more informed view of what it is worth. They can also get more out their discussions with their accountants and advisors.
- It gives an advantage in negotiations if the vendor has some understanding of the way the purchaser looks at and values the business.

To amplify this last point, in Section 1.6 the point was made that vendors may want to get the price they are hoping to achieve on to the table early so that they set expectations and let the purchaser know they are not going to sell cheaply. Another school of thought says it is better to wait for the purchaser to make the first offer, (maybe they will come in higher than anticipated), and then negotiate from there. Either way, the vendor needs to understand how their business can be valued.

So in this section we will go through some of the most common methods of valuation. It will not be exhaustive and we will focus on the most often used approaches – and it will be a simple overview. This is not going to be a lesson in accounting and corporate finance! The vendors will have expert advisors who can go into the detail but the aim is to arm them with the principles of valuation.

We will focus on 4 methods of estimating the value of a business:

- Market Value
- Multiple of earnings
- Discounted Cash Flow
- Asset value

2.2 Market Value

This way of valuing a business is the simplest, but works only if it is a quoted company, or if there are comparable quoted companies or if there have been recent sales of comparable companies.

If a company is quoted on a recognized stock market, then its market capitalization is known and published. The difference between that and any actual valuation, (almost always higher), is the bid premium. A purchaser will often pay a bid premium because the business has strategic value for them and/or they are able to extract higher earnings from the business were it in their ownership, for example:

- They can increase sales by giving the business access to their distribution system (revenue synergies).
- They can lower costs by merging certain back office functions (cost synergies).

If the company is private there may still be, in effect, a market value because there are very similar companies that are quoted and/or there have recently been enough sales of similar companies to estimate market value. This will only ever be a very rough guide, because no two companies are ever exactly the same. If a company is private it is much more likely that the other methods of valuation will be used.

2.3 Multiple of earnings

This is probably the most common method and will be referenced even if other methods are used as well. The valuation is expressed as a multiple of earnings. Breaking this down into two parts, the earnings and the multiple.

EARNINGS

It is not as simple as saying earnings = profit. Gross profit, or Profit before Tax, (PBT), can be factored down to take account of interest payments, tax, depreciation of assets and amortization. Profit that does NOT take account of all of these is known as EBITDA (earnings before interest, tax etc).

A purchaser may focus on different levels of earnings and many will focus on EBITDA because none of those items will work the same if they own the business. They may pay off loans (reducing interest). They may recapitalize, (reducing or increasing capital expenditure and therefore depreciation), or the business may not have significant capital invested, (e.g. a people business). Not will even the tax liability necessarily be the same under new ownership. So earnings for a purchaser, (or the vendor), can be looked at as a number of levels of profitability – EBIT, EBITDA, PBT/PAT, (profit before or after tax). They may use more than one and make comparisons.

It can get complicated and as noted it will depend on what type of business we are valuing. The ones above are the most commonly used, but the point is to be aware of all of them, understand the differences and compare 'apples with apples'.

Then we have to look at 'Future Net Maintainable Earnings". In plain terms – what can we expect this business to earn in the future. A lot of complicated sums can go into estimating this but the main headings are:

- Past Results – track record over the last 3-5 years and the volatility of those results.
- Netting off exceptional items – perhaps the earnings have been affected by one off events, (a fire in the factory), or include costs that will not be incurred in the future, (an extravagant car policy for the directors!).
- Competition and market forces – will the market become more or less competitive, is it growing or declining?
- "Other" – there are many other factors that can be taken into account eg. Government legislation, technology, international factors.

This question of future earnings is raised here because it impacts on the final multiple. Whatever method of arriving at a multiple one employs – these are covered next – one must take account of future maintainable earnings.

If past results are highly volatile and the market is declining the purchaser may want to discount, (lower), the multiple. If the past track record is solid and the market is growing they may be prepared to pay a higher multiple.

What they are doing in effect is producing a schedule of what they think the earnings will be, taking into account a number of factors. The vendor will have some kind of forward plan but they can relook at this through the eyes of the purchaser to a certain degree.

MULTIPLE

If at all possible the purchaser will look at the published multiples of publically owned/quoted companies in the same sector. They will then discount these for a number of factors:

- Size – smaller businesses attract lower multiples, (typically 15-30% lower as a rule of thumb)
- Marketability – what other buyers for shares in this company are there out there?
- Diversity/Risk – companies that are less diversified are felt to carry more risk, (although this is debatable)

There are many other factors. The point is, even if the sector is trading at a multiple of 10 times earnings, a purchaser may only feel this business is worth 7 times its current annual earnings.

Note: P/E's quoted on the stock market are the inverse of the earnings per share – or another way of putting this is that they are the market capitalization, (price per share multiplied by number of shares), divided by last year's earnings after tax.

If the business is trading higher than the previous year, the vendor will want any valuation to be based on current year profits. If growth is projected for the business, they will want the price to reflect this – in other words they will want the multiple of earnings used to value the business to be increased. As outlined in section 1.9, the purchaser may opt to offer some form of an earn-out – a further consideration over and above the initial consideration dependant on future performance.

This is only an overview of what at first sight seems a very simple concept. The multiple value is a certain multiple of the current earnings. But how the profits are calculated and what multiple is applied is a mixture of art, science, circumstances, gut feel and crystal balls!

Since a key reason for the vendor looking at methods of valuation is to see their business – the opportunity of buying their business – through the eyes of the purchaser, there are two other things to be borne in mind about the Multiple methodology.

- Purchasers, especially if they are public companies, want all acquisitions to be earnings accretive, or in plain terms they make a bigger return for their shareholders by buying this business. If they, the purchaser, trade at a PE ratio of 15 and buy the vendors business for 7 then it will increase their profitability, (assuming the acquired business maintains or increases profits). Often the deal is earnings dilutive in the first year after the purchase, in plain terms it

reduces the purchasers' profitability. In this case they have to make a cogent argument – based on projected revenue or cost synergies – that in future years it will be earnings accretive.

- The purchaser may already have made, or is planning to make, purchases of other, similar, businesses. The price they pay for your business will be most often quoted as a multiple of current earnings. If they pay a higher multiple for your business than they have paid in the past or want to pay in the future they make a rod for their own back. They will have to explain, (to their board, their shareholders, the press or future targets), why.

It is worth the vendor understanding generally how the Multiple valuation works and specifically these two last points, because that explains the job that they and their advisors will have to do. They have to present the most credible picture of future earnings, (expressed in the most relevant form of earnings), and the most persuasive arguments for the highest multiple to justify the highest price.

2.4 Discounted cash flow

This method of valuation is not so commonly used and, if it is, it is often used as a back-up to the other methods. It requires the purchaser, (or vendor), to be able to predict future cash flows with some degree of certainty. This is easier in some businesses than others. For example a media company that owns a number of outdoor poster sites and has long term contracts with its customers, the advertisers, can predict its income with some confidence. Its costs are straightforward so the earnings can easily be converted to a flow of cash, an annuity.

The purchaser can then do a simple DCF valuation, but in order to do so they must decide:

- The number of years they wish to look at
- The discount rate or their own ROI they wish to apply

For example, they may take the view that an acquisition must pay back in 5 years. And they might choose a figure over the base rate of interest as the Return on Investment they want to achieve, (or some other discount rate they wish to apply), of 15%. They then look at estimated future cash flows, say these are \$5 million per year.

$$\text{Year 1} = 5,000,000/1.15 = \$4,348,826$$

$$\text{Year 2} = (5,000,000/1.15)/1.15 = \$3,780,718$$

$$\text{Year 3} = ((5,000,000/1.15)/1.15)/1.15 = \$3,287,581$$

$$\text{Year 4} = (((5,000,000/1.15)/1.15)/1.15)/1.15 = \$2,858,766$$

Year 5 = \$2,485,884 (having now applied the discount, that is to say divided \$5 million by 1.15, five times)

The Discounted Cash Flow value of the business is \$16,761,775

So a business that will, they believe, deliver \$5 million cash per year over the next 5 years is worth \$16.8 million today.

Now imagine the Profit after Tax of this business is \$ 4 million, (less than the cash flow because non-cash items, such as depreciation, have been deducted). The DCF valuation is in effect a multiple of just over 4 times earnings (i.e. PAT).

In this case the DCF valuation could be used to justify a valuation of somewhere between \$15 and \$20 million that might have been determined by a valuation based on a multiple of between 4 and 5.

For a simple business, like the example of the Media company that owns outdoor posters, a 4-5 multiple of earnings may be realistic and is justified on the basis of the DCF valuation.

2.5 Asset Value

The last method is mercifully straightforward, or at least fairly straightforward apart from a couple of items!

A business can also be valued according to the assets it owns less the liabilities it carries. So for example, if it owns \$100 million worth of plant, machinery, stock and its debtors book and it has creditors and loans that amount to \$25 million, it is worth \$75 million.

The first issue is how you value the tangible assets:

- Book Value – how they appear on the balance sheet
- Replacement Cost – what they would cost to replace
- Realizable Value – what you could sell them for
- Insurance Value – what they are insured for

A bit like the overall value of a business you never know, unless you sell them, precisely what assets are worth, but it is normally possible to arrive at a fair valuation of tangible assets.

What is much harder is the valuation of intangible assets such as patents, intellectual property rights, the value of any brands and trademarks.

Then there is Goodwill. This is in effect a catch-all since, in pure accounting terms, it is the difference between the final valuation and the asset – both tangible and intangible – value. Another way to look at it, assuming it is easy to get to a fair value of tangible assets, is to say it is the difference between how you value the stated intangible assets (know-how, brands, reputation) and what you really think they are worth.

In practice, a purchaser may undertake an asset valuation but base their offer on the multiple method. The difference between the two can also be considered to be the goodwill. Again, in plain terms, the purchaser is saying "We think the business is worth \$100 million, their asset value is \$75 million and we are paying \$25 million for goodwill".

2.6 Conclusions on Valuation

It was made clear at the outset that this is a very simplified overview of some of the most frequently used methods of valuing a business. As is often the case, "the devil is in the detail", but at least with this summary a vendor can see what areas to probe and what questions to ask their advisors:

- What benchmarks have been used to estimate market value? Are those companies really comparable?
- Which earnings should be used, which are most applicable to this business and how the purchaser will view it?
- What benchmarks have been used to look at the sector multiple? How can or should this be discounted?
- What revenue or cost synergies will the purchaser take into account?
- What do the true 'Future net maintainable earnings' look like? What costs can be treated as exceptional or non-recurring?
- What effect would this acquisition have on the purchaser's earnings, in the short term and the long term?
- What headroom does the purchaser have based on their own PE ratio?
- What multiple have they, (or their competitors), used for similar deals in the past?
- What is the fair value of the assets? How can the intangible values be valued? What is reasonable for goodwill?
- What is a reasonable estimate of future cash flows? Is this too conservative, could it be improved?
- What timescale for payback will the purchaser look at and what discount rate will they use to calculate a DCF valuation?

And putting all this altogether:

- What range of valuations do we get looking at all these methods and all the permutations?
- Which method is most advantageous for the purchaser, which is most advantageous for the vendor and which is fairest and most relevant to this business?

Posing these questions and probing the answers gives the vendor the maximum information about the value of the business and therefore the best advantage in the negotiations.

It is theoretical and it all involves, as noted above, a mixture of art, science, circumstance, gut feel and crystal balls. There is only one way to find the true value of a business – offer it for sale to a variety of interested parties and see what someone is prepared to pay.

It can get complex and the detail can be crucially important. The vendor should always ensure they have the best advice possible available to them. In most cases the purchaser will be a bigger company with access to the best professional help. The vendor needs to match this on their side and see the fees involved as an investment in obtaining the best deal. As someone once said "You don't go to a gun fight armed with a pen knife!"

HOWARD LEIGH

Howard graduated in Economics and after a short spell in UK merchant banking, joined Deloitte Haskins & Sells where he qualified as a Chartered Accountant. He transferred to the Corporate Tax Department where he further qualified with the Chartered Institute of Taxation.

In early 1986, Howard established Deloitte's Mergers and Acquisitions Group and developed an expertise in company sales. In May 1988 he left to set up Cavendish Corporate Finance.

Howard is a frequent lecturer, author and broadcaster on mergers and acquisitions.

Howard was until recently the Chairman of the Faculty of Corporate Finance of the Institute of Chartered Accountants, which represents some 5,000 corporate financiers. In 2008, he was awarded the Faculty's Outstanding Achievement in Corporate Finance award. Howard is also an alternate to the President of the Institute serving on the Takeover Panel.

Howard is Vice President of M&A International Inc, the world's leading independent and largest corporate finance network, covering some 40 firms in 30 countries. He is a Treasurer of the Conservative Party and chairs a number of charitable concerns.



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