A Review of Business Valuation Methods Available to Buyers

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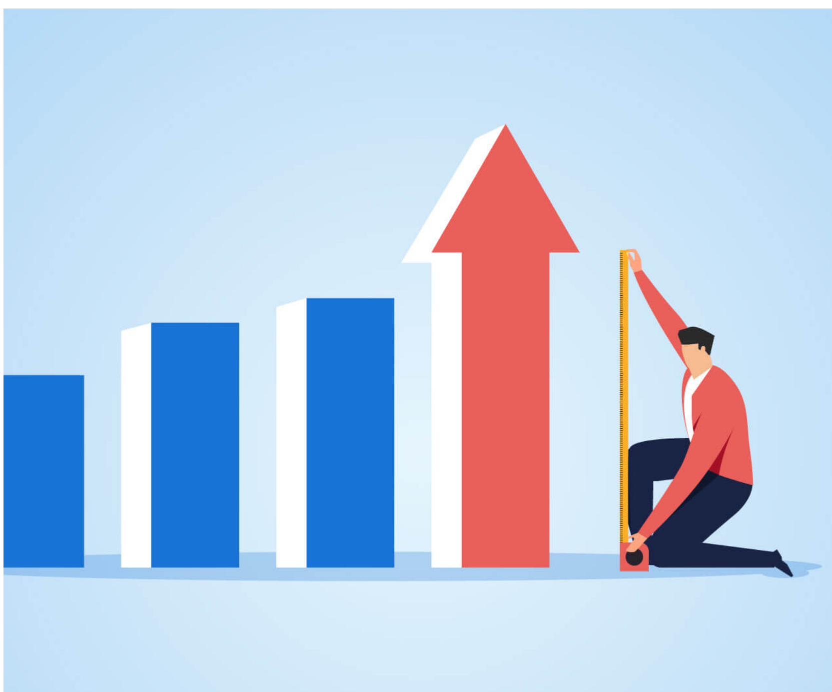

Establishing an accurate value of a business, whether you're on the buy-side or sell-side, is an essential component of extracting value from a transaction.

The most successful investors of all time are those that are better able to value assets. And while you can add value to a transaction through a successful integration, paying the right price for a company gives you the best platform to do so.

Thankfully, there are a plethora of ways in which a business can be valued.

You don't need to be an expert in every one - most buyers usually settle for one or two, with the second mostly serving to confirm the figure that the first method gave - but there's no excuse for not mastering at least one.

Mastering at least one method of business valuation reduces the chances of you joining the thousands of acquirers that overpay for assets every year.

We, at DealRoom work with many companies on their M&A process so we have some expertise in this topic.

We will begin with the mostly commonly used (and indeed, misused) of all:

Business Valuation Methods

1. Discounted Cash Flow Analysis
2. Capitalization of Earnings Method
3. EBITDA Multiple

Tools

- Pipeline management
- Diligence management
- Integration management
- Divestiture management

4. Revenue Multiple
5. Precedent Transactions
6. Book Value/Liquidation Value
7. Real Option Analysis

1. Discounted Cash Flow Analysis

Discounted cash flow analysis uses the inflation-adjusted future cash flows to project a value for the business.

The thinking behind DCF Analysis is that free cash flows are what endow shareholders with value, so FCF is the only number that matters.

The problem then arises of how to accurately project discounted FCF, using a weighted average cost of capital (WACC) several years into the future.

Even small differences in the growth rate, the perpetual growth rate and the cost of capital can lead to significant differences in valuation, fueling criticism of the method.

2. Capitalization of Earnings Method

The capitalization of earnings method is a neat, back-of-the-envelope method for calculating the value of a business, which in fact is used by DCF Analysis to calculate the perpetual earnings (i.e. all those earrings that occur after the terminal year of the DCF Analysis being performed).

Sometimes called the Gordon Growth Model, the Capitalization of Earnings Method requires that the business have a steady level of growth and cost of capital.

The numerator, usually the free cash flow, is then divided by the difference between the discount rate and the growth rate, expressed as fractions to arrive at an approximation of a valuation.

3. EBITDA Multiple

The EBITDA multiplier is an excellent solution to the arbitrary nature of most valuation methods. Even Aswath Damodaran, the father of modern valuation says that any valuation of a business should follow the law of parsimony: the most simple of two (or more) competing theories should hold sway in an argument.

On this basis, the EBITDA multiple - the multiplication of this year's EBITDA figure by a multiplier agreeable to both the buyer and seller - is an elegant solution to the valuation dilemma.

Even those who consider this method too simplistic tend to use it as a guide for their valuations, underlining its strength.

4. Revenue Multiple

This is essentially the same as the EBITDA Multiplier method with one advantage: It can be used in those circumstances where EBITDA is either negative or isn't available for some reason (usually because sales figures are the only ones available when researching firms to acquire through online search).

Again, while you might say it's just a benchmark - others would argue, with some justification, that the total sales of a business is the most important benchmark of all.

5. Precedent Transactions

This method may incorporate the EBITA and revenue multipliers or any other multiple that the practitioner so wishes to use. As the title suggests, here the valuation is derived from comparable transactions in the industry.

So, for example, if widget makers have been trading at multiples of somewhere between 5 and 6 times EBITA (or net income, or whatever indicator is chosen), Widget Co. would establish its value by performing the same iterative process.

The problem that then arises, is how similar are companies to others, even in their own industry?

Thus, for our money, this is more of a barometer of the market than a valuation method per se.

6. Book Value/Liquidation Value

The liquidation value,(which is essentially the same as the book value) is what Warren Buffett claims to have always looked at when seeing if businesses are overvalued on the stock market or not.

The liquidation value is the net cash that a business would generate if all of its liabilities were paid off and its assets were liquidated today.

In a sense, calling this a valuation method for a business is a misnomer - this only gives you the value of part of the business.

But, to paraphrase Buffett, it allows you to see the 'margin of error' that you have with a valuation.

The logic goes that, even if everything goes wrong in management and the company's sales fall dramatically after the acquisition, it can always fall back on the liquidation value.

7. Real Option Analysis

Proponents of real options analysis look at businesses as nothing more than a nexus of real options: the option to invest in opportunities, the option to utilize spare capacity, the option to hire more salespeople, etc.

Bringing together these options is the basis behind real options analysis for valuation.

This is most effective for firms with uncertain futures, usually those who aren't yet cash generative: startups and mineral exploration firms, for example.

Of the valuation methods on this list, it's by some distance the most complicated but its proponents include McKinsey and several of the world's most prestigious business schools.

Closing Remarks

Any valuation model is only as useful as the inputs used.

Perhaps what links all of the methods mentioned here is that their users have, at one time or another, plugged numbers into a model which gave a number they thought was erroneous, only to replace the numbers moments later to arrive at a number they considered ‘**more reasonable**.’

The best advice is to use as many measures as possible to arrive at a valuation, assuming the data are available to you.

The more insights you can garner on its revenues, EBITDA, free cash flows, assets and real options, the better a perspective you gain of the company’s true value.

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Manage all your deals & contacts in one place

Diligence

Speed up and simplify due diligence process

Integration

Plan for integration alongside diligence

Divestiture

Transform how you divest parts of your business

PRODUCT

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Due Diligence Software

Post Merger Integration Software

Virtual Data Room

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M&A Deal Management

M&A Pipeline Management Software

Deal Flow Software

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