

Valuing your Business

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This article mainly focuses on determining the value of your business and how to attract potential investors.

Main Points in this article:

- 1 Develop a valuation model that accurately reflects the underlying elements of the business.**
- 2 Strong competitive advantage drives sustainability of earnings.**
- 3 Capital flows towards companies with sustainable earnings.**
- 4 Valuation methodology will be influenced by stage of investment.**
- 5 Check the valuation range against valuations of comparable companies.**

Valuation influences many management decisions.

These decisions may involve valuing your own business for the purposes of capital raising, or for the purposes of determining value for an unexpected bid from one of your competitors.

Valuation decisions are also important for your own acquisitions, joint ventures, strategic investments or new business opportunities.

The key issue for management is to develop a model that accurately reflects the underlying elements of their business.

To do this, management needs to create robust financial projections, select appropriate valuation methodologies, determine the parameters (like discount rates or other variables) and then compare valuation ranges with similar companies.

Once the valuation range has been determined, the CEO/founder will be in a much stronger position to negotiate with potential investors.

Investors or potential acquirers will develop their own forecasts and create their own valuation models. Investors are always seeking “undervalued” companies where they believe they can do things differently and improve earnings.

Investors focus on the earnings potential of the business, the

management capabilities and the company’s competitive advantage.

It is therefore important to develop some robust financial projections.

Financial Projections

The financial projections will determine whether your business is an attractive and sustainable investment proposition. See the “[Preparing Financial Projections](#)” article at this Website for further information.

Projections need to be prepared for a period of up to 10 years. Since the assumptions may change, due to industry factors, power of competitors, suppliers or buyers, it may be appropriate to divide the projections into two periods: first 5 years and second 5 years.

The key issue is whether the earnings over the invested capital will exceed, or fall short of your cost of capital. The cost of capital is calculated by adding the cost of equity and the after tax cost of debt in their respective proportions. Although the cost of capital calculation has been simplified, it is actually known as the weighted average cost of capital.

If for example, the return on invested capital is less than the cost of capital, the company is unlikely to generate sufficient cash to stay in business. The time to break-even is a critical consideration.

If the return on investment is in line with the cost of capital, then the company is at least profitable, although it may not be generating the level of returns required by investors.

Like the earlier example, the company may not yet be sustainable and have some difficulty attracting investors.

Investors, on the other hand, may be more interested if the returns on investment exceed the cost of capital. VC managers seek to achieve returns (IRR) of 25% and above on their investments.

Sustainability is a key issue and is driven by strong competitive advantage. Capital will always flow towards sustainable companies with improving earnings.

Some time ago, the buy/hold/sell recommendations of various brokers for listed IT companies were reviewed. It was evident that the companies with strong earnings rates, expressed as EBITDA to Sales above 20%, had “buy” recommendations. Earnings sustainability is just one factor the brokers look at, but it is a very important one.

Valuation Methodology

Once the financial projections have been developed and different scenarios considered, it is necessary to consider the most appropriate valuation methodology.

This methodology may be influenced by the stage of the investment (seed, start-up, early or late expansion, bridge funding), the proposed form of exit (IPO or trade sale), or company specific factors (revenue growth, margins, return on investment rates).

Generally, there are two main valuation approaches:

- Capitalisation of earnings, or
- Discounted cash flows.

Capitalisation of Earnings

The capitalisation of future earnings approach is based on using an appropriate multiple and applying that to the projected earnings.

This approach is fairly widely used in both the public and unlisted markets and is easy to understand. It does however have some difficulties with the calculation of “maintainable” earnings and the selection of appropriate multiples. Is it a price earnings multiple, or an EBIT or EBITDA multiple or a cash flow multiple?

For example, if the price earnings multiple is used, the calculation is the price earnings multiple by the net profit after tax figure. If the company is trading at a price earnings multiple of 10 and has a net profit after tax of \$5 million, the implied valuation of the business is \$50 million, assuming no debt.

This valuation method is generally not suitable for companies in the seed, start-up, or early stages of development. It is also inappropriate for “turnarounds” or loss making companies.

The selection of the multiple and earnings estimates will be of significant interest to the potential investor. If the multiple increases and the earnings grow, there is a double whammy effect. Two separate factors are working together to provide an uplift in the valuation.

VC managers are keenly aware of this dynamic. Essentially, they want to buy low (with low multiples) and add value (by boosting earnings) on the way through.

Discounted Cash Flows

The discounted cash flow approach is generally used to value companies, acquisitions, or investment opportunities where cash flows (amount and timing) are available. This approach also caters for companies in the early stages of their development, companies with lumpy cash flows or companies seeking to break-even in the near future.

The financial projections flow into the discounted cash flow model. The issues for this approach relate to the selection of the discount rate and the calculation of the “terminal value” at the end of the forecast period.

Depending on the stage of the investment (seed, start-up, early or late expansion, or bridge), different discount rates will apply to reflect the riskiness of the business. A liquidity premium is also included in the discount rate to reflect the illiquid nature of unlisted companies.

The terminal value, depending on the future earnings potential of the business may represent a significant part of the valuation. The valuation reflects two components: valuation of earnings from current activities, and the valuation of earnings from future activities.

The terminal value is usually calculated at the end of the forecast period by using the capitalisation of earnings approach and then the amount is discounted back.

Valuation Comparisons

Having applied the valuation methodology to your forecast numbers and derived a valuation range, it is advisable to check the numbers against the valuations of comparable companies with similar economic characteristics (size, growth rates, profitability, capital intensity, and risk).

If you want to make better decisions in your business, an appreciation of its value is essential.

It involves time developing the projections and establishing a valuation model, however it prepares the CEO/founder for the capital raising process or sale negotiations.

It also provides a process for evaluating future acquisitions or other investments.

Being aware of the company's value should also extend to being aware of the dilutionary impact of future capital raisings. See the "**Valuation assuming Future Dilution**" article at this Website for more information.

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