Chapter 1 - Exploring the fundamentals of business valuation

Speakers

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Transcript

Russell:
In chapter one of 'How to Value your Business', our specialist panel explore the fundamentals of business valuations, including the key methodologies that are typically used to value a private business.

Andra:
So let's start from the top. What are the basics of business valuation, including the main methods used and how do they work in practice?

Paul:
So there are three key methodologies that are typically used to value a private business. The first is the one with mathematical integrity, and it's called a 'discounted cash flow', and it often results in a number called a net present value of all your cash flows in the future. The second methodology is using some 'comparable company analysis' where you look to benchmark your business against similar businesses that have either just been sold or are trading in the market. And the third methodology is called an 'asset based valuation', where crudely and in some cases quite depressingly, you look at your balance sheet and look at that as the valuation of your business. That often generates a great valuation for those with a very strong asset backing, but for businesses with lots of growth, it's not always the most appropriate route to take.

Russell:
Paul has helpfully outlined the three key methodologies typically used to value private businesses. The first one, 'discounted cash flow', looks to determine whether an investment is worthwhile based on future cash flows generated by the business. Now, much will depend on the assumptions that are made, and it appears to work best when there is a high degree of confidence about the future cash flows of the business.

Andra:
The second methodology, 'comparable company analysis', relies on finding data from businesses similar to yours. Now, it may not account for company specific non-financial factors and it is sensitive to the peers selected.

Russell:
And finally, the 'asset based valuation' method, which looks at the company asset value after deducting liabilities. Whilst it can be a relatively straightforward calculation, it doesn't consider a company's future earnings potential.

Andra:
So in practice, there isn't really one perfect method to value a business. Each has its pros and cons, which is why many business owners will review and possibly use a range of methods that yield a range of values.

Russell:
Having heard from Paul about the valuation methodologies in general, let's take a more specific look at how valuation methodologies are used in practice. Private Equity is one sector constantly looking at business valuations. So how do PE firms approach this topic?

Amar:
For performing businesses, the most relevant methodology is an earnings multiple based methodology. So you create a comparable measure of earnings, usually something called EBITDA, which is earnings before you deduct interest, tax, depreciation, and amortisation. And you multiply that by a multiple that is relevant for your industry to get to your enterprise value. Now, the multiple you can get by looking at similar companies that are either listed or similar transactions that have happened, and you take that multiple, you apply it to your EBITDA and you get your enterprise value.

Andra:
The EBITDA based valuation is clearly a very powerful and widely used tool to help forecast the value of a business. The calculation of EBITDA is mathematical whilst the multiple is arrived at through a combination of qualitative and quantitative factors. Based on Amar's experience, we asked: what are the notable valuation differences between industries? Does size or longevity make a difference?

Amar:
There's lots of factors that drive multiples, but fundamentally, it's how attractive the business is and the qualities of that business. So you know, how resilient are its earnings? How quickly do those earnings turn to cash? How reliable are those earnings through long periods of time? Is it insulated from macroeconomic factors? How did it trade during things like COVID or the last recession? Those are all key factors in how attractive the business is. And alongside that, people are keen to look at how attractive the market is. Is it in a big market? Is that market growing? Does the business itself have a competitive advantage in that market, which means it can keep winning in that market? And you can see that in the comparable multiples you look at, there'll be a range and that range will be driven by those specific business factors.

Russell:
So we've looked at some of the key valuation approaches. We heard earlier that no valuation method is flawless and that there are many factors that can influence the final figure or range. Given this, it might appear that it's worthwhile getting multiple valuations from a number of different advisors.

Paul:
So it's certainly advisable to ask a number of different people about the valuation of your business because valuation is an art, not a science, and people come up with different reasons. The one word of caution I would extend is not to necessarily go with those that give you the strongest picture and the strongest valuation. They may have an ulterior motive for that, and you want to make sure that the valuation you're getting is balanced and fair, and representative of what you genuinely think you'll achieve when you go into the market.

Andra:
Now, not all business owners are looking to sell their entire business. What if you only want to sell a minority share? What should you consider then?

Paul:
So selling a minority share in your business is different to selling a division of your business. It's quite often possible to sell a minority share in your business. It will depend whether you have a shareholders agreement with your fellow shareholders. And it'll depend on the appetite of the incoming buyer, whether they want a majority, they want a minority, or what they want to be doing with the shares that they own.

Andra:
Equally, some business owners are looking to sell a part of their business, so what needs to be considered when it comes to selling a division?

Paul:
Selling a division is often more complicated and it comes down to what's called operational separability. Will that division be able to survive outside of your organisation when it's owned by someone else without the resource that you are currently giving it? And as importantly, will your business be able to survive without the division you would've sold, absent the resource that you may be bringing in from the division that you're selling?

Russell:
It's clear then that there are a number of ways to approach business valuation, and it's certainly part art and definitely not all science. Different advisors will bring diverse perspectives and methodologies to the table, so it's worth seeking advice from multiple sources. We hope that our experts have given you plenty of actionable thoughts as you start thinking about the valuation of your business.

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