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How To Value A Private Company
or
Understanding Private Company Valuation

When the owners of a private company decide to sell, their key question is "how much do the owners get?" So the selling owners are really interested in knowing is what is the value of their equity. So this paper is to explain how to value a private company and the value of the equity.

The market determines the value of not only public companies, but also privately held companies as well. Because it is not a perfect market, if a company owner had five prospective acquirers making offers all at the same time, all those offers would be different. Each suitor would assess the risk associated with future earnings slightly differently. There are, however, two specific methodologies to zero in on a range of value: Enterprise Value and Net Asset Value.

Enterprise Value Enterprise Value is the primary method used for companies that are profitable and possess economic value beyond net asset value or its accounting book value. Enterprise Value reflects the earnings generating value of a company; therefore, Enterprise Value is the economic value of a company.

Enterprise Value is derived from a simple formula using the company's consistent pre-tax earnings performance times a multiple of those earnings. Although the formula is simple, the components require well thought-out evaluation in order to represent market assessment more accurately. The prospective acquirers (the market) make the assessment. Each component has definition and strength when determined in light of the company's adjusted historical earnings, industry expectations, and investor risk appetite.

- <u>Earnings</u>
  Most prospective acquirers determine their level of interest in a company based on anticipated future earnings. Historical pre-tax earnings are the primary indicator of future earnings. Demonstrated earnings determine value today. Many practitioners use EBITDA instead in their formula approach. EBITDA is an acronym for Earnings Before Interest Taxes Depreciation and Amortization. EBITDA better represents the cash generating capability of the company. Either is appropriate, and either will further be adjusted in the final analysis.

- <u>Market Assessment</u>
  Said in continuing perspective, an enterprise is a business machine that generates earnings; therefore, enterprise value is comprised of the underlying capital structure that generates those earnings for that earnings machine. What the acquirer is buying is an earnings-generating machine whose value is determined by its earnings.

As such, the predictability of those future earnings is critical to the value assessment. The certainty of those future earnings is subjected to risk. So when an acquirer considers risk he normally considers such issues as:

a. Company business model,
b. Unique market position,
c. Product position,
d. Cost position,
e. Competitive position, reputation,
f. Management strengths,
g. Gross margin percentage,
h. Operational strengths and weaknesses,
i. Location,
j. Asset strengths,
k. Customer concentration,
l. Barriers to competitive entry such as proprietary methods, systems, technology, relationships, brand names, customer approvals, patents used to create earnings,
m. The fit with the acquiring company's unique characteristics,
n. Critical mass – size does matter

These characteristics contribute to a company's risk profile that causes the acquirer to determine the multiple of pretax earnings or EBITDA the acquirer will use to calculate enterprise value. EBITDA is not perpetuity because there is risk that changes over time.

- The Multiple – Investor Risk Appetite

The earnings multiple is more subjective. It is the assessment of risk. Although charts exist, a multiple represents an expected rate of return for the investor or acquirer. The higher the risk associated with the investment, the higher should be the expected return.

A simplistic way to compare the multiple to an expected rate of return is to divide one (1) by the multiple. Therefore:

Multiple Quantified to Risk		
1 / 1 = 100%		A very risky business indeed, but retains a reasonable plan of expectations – Just short of discounted value.
1 / 3 = 33%		A company in a low margin commodity or higher risk industry sometimes in early stages of development.
1 / 5 = 20%		A company with consistent earnings history with a bright future.
1 / 7 = 14%		A larger company with revenue critical mass, barriers to competitive entry and strong future.
1 / 10 = 10%		A larger, stable, solid company with good earnings expectations together with substantial upside potential.

Expecting a 20% return, based on the risks of investing in any smaller to medium size business, is probably as low an expected return as many would accept. That's why multiples used to value many businesses exceeding six times EBITDA are less common. The investor can make greater returns in much less risky investments.

Multiple ranges vary, and the size, internal dynamics, and strategic plans of the acquirer will determine their desire for a particular business. Seller presentation is important to influence this factor.

The under carriage of the enterprise is its capital structure. The capital structure is the investment the owners have in the enterprise that it takes to generate pre-tax earnings and EBITDA. A company's capital structure is its combined equity and funded debt. The funded debt is specific and is indicated on the balance sheet. The mission is to calculate the value of the equity. The value of equity is not that indicated on the balance sheet but instead is derived from the company's enterprise value. The value of the equity is enterprise value less the funded debt.

- The Formula Interpreted Using an Example
  When a company owner considers selling, his question is, 'What do I get from the sale transaction?' Based upon a hypothetical company sale with $1,800,000 EBITDA, the answer is as follows:

  The Formula:

  Enterprise Value = Earnings (or EBITDA) times (x) a multiple.
  Market Value of the Equity = Enterprise Value – Funded Debt.
  Market Value of the Equity = Proceeds to the Owners.

EBITDA	$1,800,000
Earnings Multiple	5.0
Enterprise Value	$9,000.000
Less:	
Funded Debt	($1,430,000)
Proceeds to Owners Before Expenses	**$7,570,000**

Net Asset Value What happens if the company is not generating profits? The other approach to valuing the private company is simply using its net asset value. If a company has a high degree of risk associated with its future or is generating low, or no, earnings then the only approach available to an acquirer is to look to the net asset value. In that case, the starting point tends to be book value that is yielded by the asset value less the liabilities reflected on the company's balance sheet. The value of assets held by an unprofitable company may or may not equal the value reflected on the balance sheet.

Summary Clearly, Enterprise Value possesses certain areas of subjective assessment of both the multiple used and the future earnings stream. As such, a selling company owner must not only use good negotiating technique, but must also present his company in a positive way that supports the best valuation conclusion. This aspect is important to a seller's proceeds because it gives the prospective acquirer the greatest comfort with the company's consistent future earnings stream. Because each prospective acquirer's value assessment will differ, it is important for the savvy seller to reach as many prospective acquirers as possible.

Course of Action If you are an owner of a company and would like to know the range of value for your company, call EquiCap Partners. EquiCap would be happy to provide you with a range of value assessment without cost to you.

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