

Business valuation overview

It is a common occurrence that business owners do not know the value of their company at any given point in time. Business valuation is part art, part science, and is a very technical subject matter. There are different approaches to valuing a company and it can be somewhat subjective depending on who is performing the valuation. This article provides an overview of business valuation without getting too technical. In its simplest form, value is a function of risk in achieving future cash flows.

Types of valuation reports

If you were to hire a Chartered Business Valuator (CBV) to prepare a business valuation, under the standards of the Canadian Institute of Chartered Business Valuators there are three types of valuation reports: comprehensive, estimate and calculation. The conclusions for each type of report differ by the level of assurance provided and the extent of analysis, investigation and corroboration performed by the valuator, with a comprehensive valuation report providing the highest assurance and the calculation valuation report providing the lowest. The breadth of work performed by the valuator does not differ for the three types of reports, only the depth of analysis, investigation and independent corroboration. A calculation report is the least expensive and a comprehensive report is the most expensive. A calculation report is appropriate for most circumstances; however, the purpose of the report and its intended use are important factors.

Valuation principles and approaches

There are two basic approaches to the valuation of a company. The first is the going concern approach which is used when a company generates a sufficient level of profitability as compared to the capital assets invested in the business. The second approach is the liquidation approach and it is used when the earnings or cash flow of a company are inadequate in relation to its tangible assets. The focus of this paper is on going concern entities.

There are several going concern valuation approaches and these are based upon future earnings or cash flows or on the basis of the company's underlying assets.

Capitalized EBITDA approach and maintainable EBITDA

The Capitalized EBITDA approach is the most commonly used method for valuing a company, and therefore, is the approach highlighted herein. It is referred to universally among merger and acquisition deal makers in communicating pricing/valuation, as it ignores capital structure (i.e. debt and equity) allowing for comparability among companies within the same industry that may otherwise have very different capital structures.

The capitalized earnings before interest expense, income taxes, depreciation and amortization ("EBITDA") approach involves estimating the maintainable EBITDA a company can reasonably be expected to generate in future years. Maintainable EBITDA is represented by the pre-tax operating cash flow or EBITDA of a business that is expected to be sustainable over an extended period of time. Often adjustments, such as to management/shareholder salaries or other specific non-recurring items or events must be made to normalize historical EBITDA and assist in determining the future maintainable EBITDA.

The multiple

A multiple is the inverse of a capitalization rate (or risk rate) which reflects both the industry-related and the company-specific risks and opportunities associated with the business. In its simplest form, value is a function of risk in achieving future cash flows. The multiple is influenced by a variety of factors, such as:

Size – investors correlate larger size with lower risk. The larger the size, the more diversified the business is and better suited to handle any downturns, so a higher multiple would be applied.

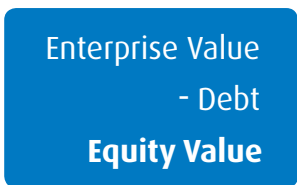
Growth Opportunities – track record of organic growth and credibility of future growth strategy, accretive M&A opportunities, industry/sector growth. A business plan with well-defined, actionable growth opportunities is critical to obtaining a higher multiple.

Risk profile – revenue attributes (customer concentration, recurring revenues, etc.), supply dependencies, strength and stability of management team, sector risk and cyclicity of the business. A higher multiple would be used for a less risky business.

Capital Requirements – less capital intensive businesses command higher multiples. Cash is king and higher annual capital outlays can increase risk.

Enterprise value, equity value, and the components of business value

A multiple is applied to the maintainable EBITDA in order to determine the total value of a company (or “enterprise value”). Enterprise value represents the value of the business prior to deducting debt. Equity value of a business is therefore enterprise value less debt. An easy way to understand enterprise value and equity value is to relate this to the ownership of your personal residence. Most people “own” their home with a mortgage provided by a bank. The enterprise value is the value of the home and equity value would be the value of the home less the mortgage (i.e. debt). Enterprise value is what a buyer pays on the purchase of a business and equity value is the net amount received by the seller after paying off existing debts.



Enterprise value is comprised of net working capital (calculated as current assets less current liabilities), tangible assets (land & building, equipment, etc.) and the excess (if any) is attributed to intangible assets or commonly referred to as goodwill. Examples of goodwill or intangible assets include customer lists/relations, employees, brand, proprietary technology, trade secrets, patents, etc.



As the diagram depicts, risk increases for the different asset categories due to liquidity and complexity. Accounts receivable is generally less risky than a piece of machinery/equipment and even less risky compared to the goodwill in a business.

Rule of thumb valuation approaches

Many industries have a known ‘rule of thumb’ approach to valuation which is often discussed amongst business owners; however, this can be very misleading for a myriad of reasons and should not be solely relied upon. Rules of thumb should not ever be the primary approach to determining value but can be used as another approach to compare to the primary approach. A business valuation is unique to the business being valued and a detailed assessment of the business should be completed.



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