

Valuation





Foreword

Valuation should be considered to be an 'art' rather than a 'science', as at the end of the day it comes down to judgemental factors given all the relevant information available. It is for this reason that any professional Adviser will use extensive caveats and words like 'in my professional opinion' and then promptly give a valuation range.

After all we have to remember that the value of anything is what someone is willing to pay for it!

From a professional point of view Valuation reports are often controversial documents as depending on the purpose there is often two or more parties looking to gain something different from the report. Therefore our judgemental decisions about multiples and discount rates will come under close scrutiny.

Critchleys corporate finance team can draw on specialist expertise to provide you with comprehensive financial advice. Our experts in corporate tax, VAT, accounting, audit and financial planning are on hand to advise on broader issues affecting the success of your business. This multi-disciplinary approach provides a level of service which stand-alone corporate finance boutiques find hard to match.

We offer a full range of services to help you achieve your business ambitions and measure our success by your success. Critchleys' experienced corporate finance professionals have the expertise, contacts and commercial acumen to effectively negotiate and conclude deals - and an impressive track record to prove it. We are committed to providing sound commercial advice to the mid-market, and have particular expertise in owner-managed businesses and SMEs.

Should you wish to discuss any aspect of your corporate finance needs please contact Justin Ray on 01865 261100 or jray@critchleys.co.uk

Justin Ray

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Key Queries

For what purpose is the valuation?

There may be many reasons for a business to consider its value:

- Linked to a planned disposal
- The buying-in of a minority shareholder
- Inheritance Tax
- A planned merger

Each reason will have a different overall approach resulting in a potentially different outcome. Therefore before any work is started the precise scope and purpose of the valuation must be established.

What is the difference between Enterprise Value and Equity Value?

There is often much confusion as to what value is being talked about:

Enterprise Value: When a valuation has been derived using multiples of profit before interest (such as EBIT, EBITA, and EBITDA see later for definitions) the business has effectively been valued on a debt and cash free basis. In other words it ignores any funding on the balance sheet.

Equity Value: Equity value represents the actual value that would accrue to the shareholders. This can be either calculated by taking off the debt of the business from the Enterprise Value above or valuing the business based on multiple of profit after interest (for example PBT and PAT see later for definitions).

What is the difference between Fair Value and Market Value?

Often when valuing minority stakes in a business there may be set valuation parameters laid out within the legal framework of the business (for example in the Articles or Shareholders Agreement).

- **Market Value:** the value of the shareholding if it were sold in the open market by a willing buyer and a willing seller.
- **Fair Value:** as above but it also allows the valuer to take into account other external factors and in particular to the precise circumstances of the valuation and the parties involved.



Valuation Methods

A) Discounted Cash Flow (“DCF”)

The DCF method of valuing a business is based on the economic principle that an investor is concerned with cash flows from an investment and with the risk associated with those cash flows.

A financial model is required that projects cash flows for a number of years in the future and then calculates a final "terminal" value. These cash flows and the terminal value are discounted at an appropriate rate to reflect the cost of capital.

The skill is therefore two – fold:

- Producing a robust set of forecasts
- Deciding what cost of capital should be used

This method is considered by academics to be the purest form of business valuation because it considers cash flows rather than an estimate of earnings which can be distorted by accounting policies, such as depreciation and provisions.

The accuracy and reliability of using this method depends on the quality of forecasting; the timing of cashflows; and determination of the most appropriate discount rate. The DCF method is therefore most applicable in valuing long - term projects where both cash flow and cost of capital can be “accurately” forecast or where the business is in a turnaround situations.

B) Earnings Based Methods

Valuation techniques based on multiples of profit is in practice the most common method of valuation an enterprise. Although quite simplistic in its approach it does tend to equate to the same valuation range as that achieved by the Discounted Cash Flow technique.

What multiple should I use?

There are in essence two ways to formulate a view as to appropriate multiple:

- Comparable Company Analysis: this method uses current market share prices of listed companies that have comparable characteristics to the business reviewed to determine a multiple.



Due to factors such as the size of the business; the illiquidity of private companies and the relative size and financial strength of the business as compared to the listed organisation it is usual that a discount is applied to the listed multiple. The range of discount is usually between 10% to 50% depending on the matters at hand.

- **Comparable Transaction Analysis:** this method uses the valuation multiple (where it is disclosed) in historical transactions involving a target with similar characteristics to the business at hand.

There are however issues that need to be considered when using multiples based on such historical data:

- Not all transactions report the consideration;
- Those that do often include other payments not necessarily linked to the value of the business; for example payment made for excess cash
- The disclosed multiples will relate to historic profit and have no recourse to the forecast profitability of the business
- Similarly the historical profits used would not have been adjusted for any non-recurring items or any add backs such as excessive directors remuneration.

All of the above will need to be considered when deciding on the most appropriate multiple to use. But at the end of the day it will be a judgement call taking into account the size of the business; the sector; the forward order book or specific contracts; and identified opportunities.

What profit figure should I use?

Different situations may warrant the use of different definitions of profit. For example Profit before tax (PBT); profit after tax (PAT); EBIT (earnings before interest and tax); EBITA (earnings before interest tax and amortisation); EBITDA (earnings before interest tax, amortisation and depreciation) are all valid assumptions on which to base any valuation.

Care needs to be taken to ensure that the right type of multiple is matched to the right type of profit stream.

- Profits before interest use EV ratios to calculate Enterprise Value
- Profits after interest use PE ratios to calculate Equity Value



A similar question is what bias, if any, should be made to historical profits ; current 'run rate'; or forecast profit over the next few years?

In addition there are certain adjustments that may need to be made to any figures. For example any one off non-recurring items; write offs; and exceptional gains or losses should all be adjusted for, as should any excessive or indeed abnormally low directors remuneration.

The concept to bear in mind is what is the **Maintainable Profit** of the business.

C) Net Asset Method

The valuation of an asset is the value of its future earnings stream.

It is for this reason that most profitable businesses will be valued not according to its balance sheet worth but more over its ability to generate profit from that balance sheet.

Valuations with reference to the balance sheet is usually done to show the break up value of a business and therefore represents the worst case scenario.

There are however exceptions. For example property companies or investment companies will be valued based on their asset portfolio. In these case the balance sheet should be re-valued

D) Other Ad-Hoc Methods

In certain industries there are other rules of thumb methods of valuation:

- Hotels: multiple of room rate and occupancy
- Publishing: multiple of turnover