

# What is Your Business Worth?

A Little Mathematics And a Lot of Common Sense

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STIRLING MERCANTILE  
CORPORATION

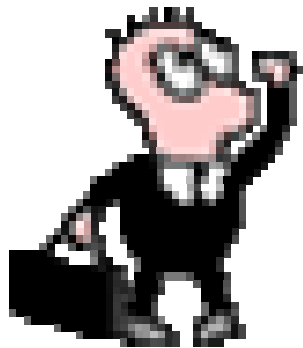
# The Customary Way

Hmmm, how much do I need to live when I retire?

OK, then take the \$250,000 per year that I make now and, using the Canadian Bond rate of 5% ( 'cause I'm sure not going to take any risks !! I DID that !) I would need, ummm (\$250,000 divided by 5, ummm, carry the 10... ummm no that's not it.)

OK I would need  $\$250,000 / .05 =$   
 $\$5,000,000.$

So that's what my business is worth. "Cause that's what I need.



# Another Way

You are talking to your long time accountant:

You ( in the suit): Hey Aloisius, what's my company worth?

Aloisius (thinking to himself): OH RATS! Why does he want to know? I'm going to lose that juicy auditing file. Now how am I going to get that boat? I'd better talk him out of it. I know, I'll talk about the tax consequences, that'll scare him out of it.

But says, " Hmmm.... Let me think about that".



# Another Way, Cont.

And eventually comes back to say;

**“It’s worth Book Value ”**



(after all, from his professional point of view and training, how could it be worth anything else? That’s what he just told your Bankers too. It had better be Book Value or he’ll have to turn in his licence !)



# The Real Answer

- It depends on a lot of things.
  - Sustainable profitability?
  - Size of the company.
  - Market leader/sustainable competitive advantage?
  - Future cash flow expectations and costs to maintain.
  - Industry Type and Stage (cyclical or steady, advancing or declining).
  - Management and your role in the business.
  - Who you are selling to. Financial Buyers vs. Competitor or Strategic buyer.



# The Real Answer, Con't.

- Also depends on
  - your loyalty to your employees
  - your customers loyalty to you
  - how much debt capacity your company has.
  - the tax position of the Company
  - Yes, we'll admit it.. The accounting book value of the Company.



# The Principals of Value

- All businesses can ONLY be worth what they will generate in cash for the owners IN THE FUTURE.
- All investors/owners have rates of return in mind which they require for their investments.
- Investors prefer a higher return than a lower one.



# The Principals of Value, Con't.

- Therefore a buyer will be willing to pay no more than the amount which allows him to earn the required rate of return from the free cash flow from the business.
- The more risk, the higher the return required.
- The return requirements reflect either a personal preference or, what the investor could get as a return from a similar investment ( say a public company in the same business).
- Leverage (the ability of the Company to carry debt) has an effect on value by increasing the use of bank debt as part of the purchase price. Also increases risk though.
- “ Strategic” value also affects the value of a business.



# More Principals

- Strategic Value is really just the ability of the buyer to make more money than a financial buyer by either reducing costs or increasing revenues or both. I.E. a competitor who buys your business and then fires all the employees as redundant.
- Strategic buyers will pay more under the right circumstances, but don't expect them to pay for something that they alone bring to the table.
- Lastly, if you only have one bidder, your going to get the lowest price, not the highest.



# How value is calculated

- That darned book value again, (less all of those off balance sheet liabilities you

were hoping would go away, and the accounts receivable that you owe yourself, etc, etc. all called the adjustments.)

Calculation of the Net Present Value of the cash flow from the Company in the future (plus or minus the same adjustments as above).

- EBITDA multiple basis. (ditto).
- The most common is the EBITDA multiple basis because people have difficulty doing exponential calculations in their heads for the NPV method.



# More Value Calculations

- Note that some of the methodologies give you the value of the whole Company called the Enterprise Value (EBITDA multiple) whereas others (Book Value) can give you both the equity value and the Enterprise Value. You have to be careful to make sure you deduct all long term debt from the EBITDA multiple method or alternatively, that you use the real free cash flow to investors ( i.e. after taxes, capital expenditures and principal and interest payments) if you are doing a Net Present Value Calculation.



# Value Calculations, Con't.

- Question: OK, but which method do I use?
- Answer: The one which gives you the highest value !
- No,... really.
- Actually, Formal valuations will use 2 or even all three methods and then weight the answers appropriate to the situation.



# Still More Value Calculations

- Different methods are more or less valid depending on the situation. E.G if your company is about to enjoy a significant lift in earnings then the Discounted Cash Flow method usually reflects reality best. On the other hand if the Company has steady earnings but considerable asset value then the adjusted Book Value works best.



# Additional Value Calculations

- Another important factor is “Comparables”
- This is information about what other investors have paid for similar businesses.
- It, in effect indicates both the average EBITDA multiple and the required rate of return used for pricing similar businesses.
- Public Company and Private Transaction information is collected from various data bases.



# Further Value Calculations

- Once an average EBITDA multiple or rate of return is calculated, the answers will be adjusted to fit the circumstances.
- E.G if a public company EBITDA multiple of 5 is in evidence, you might be willing to pay only 4 times because its easier to sell shares of a public company than a private one. (the “Liquidity Discount”)



# Continuous Droning On About Value Calculations

- Alternatively if the EBITDA multiple is 5 times, but the buyer can earn higher margins on both his business and yours, then he might pay 6 or 7 times EBITDA. (the “Strategic Premium”).



# Won't that guy just stop about the Value Calculations

- If a Net Present Value calculation is being done, then you need a 5 or more year forecast of your business and the right rate of return to use for the discount rate. This rate is also adjusted from an average to reflect higher or lower risk, liquidity, and special circumstances.



# OH NO ! The Math part! of Value Calculations

- Here's some examples.
- Assume your business earns \$1 Million a year in EBITDA. It has modest growth of 5% per year and a solid track record, management team, and prospects (i.e. no reason for any significant adjustments).
- The Company also has \$2 Million in term debt.
- An examination of comparable public company EBITDA multiples and transactions shows a 6 times multiple and a 15% return on investment.



# Math..... Run !

- So, if public company EBITDA multiple is 6 x's, the private company status suggests a discount to 5 times.
- Therefore \$1 Million x 5 = \$5,000,000  
less: Long Term Debt = \$2,000,000  
Shareholder Value = \$3,000,000

Have fun on your boat!



# Please Make Him Stop !

- To do the NPV Calculation you need to forecast the Free Cash Flow of the business, say for 5 years. Free Cash Flow is Net after tax Income plus depreciation minus capital expenditures needed to stay in the business and minus long term debt principal payments. If you have been taking out more than it would cost you for a professional manager to take your place you can add the difference to FCF. Lets assume Free Cash Flow grows at 5% per year and lets assume you have \$350,000 per year in depreciation, but it only really costs you \$200,000 in annual maintenance capex.
- Have to assume a 5 year term on the long term debt (at say 7.5% interest) and a tax rate of say 25%



# Aaarrrrghh,, my eyes!

	2006	2007	2008	2009	2010
EBITDA	\$1,050.0	\$1,102.5	\$1,157.6	\$1,215.5	\$1,276.2
less: Interest	\$150.0	\$120.0	\$90.0	\$60.0	\$30.0
Tax	\$137.5	\$158.2	\$179.4	\$201.4	\$224.1
Principal Payments	\$400.0	\$400	\$400	\$400	\$400
Maintenan ce Capex.	\$200.0	\$200.0	\$200.0	\$200.0	\$200.0
Equals Free Cash Flow	\$162.5	\$224.3	\$288.2	\$354.1	\$422.1



# Babble Babble, Value Babble.

- There's more! You have to either have such a long forecast (25 years) that the NPV represents effectively all of the cash flows, or you have to assume a Terminal Value ( based on the 5 years EBITDA times a multiple and minus long term debt at the time).



# I'm plugging my ears !

- So Lets just use 5 times the 5'th year EBITDA of \$1276.0 and there will be no debt because you paid it off.
- Terminal Value =  $\$1,276.0 \times 5 = \$6,380.0$
- So the cash flows to be discounted are;

	2006	2007	2008	2009	2010	Terminal value
Free Cash Flows	\$162.5	\$224.3	\$288.2	\$354.1	\$422.1	\$6,380.0
NPV at 15%	\$4,221.6					



Wait, Wait, THAT was interesting!

EBITDA method = \$3 Million Shareholder  
value

NPV Method = \$4.2 Million Shareholder  
Value

Hooray, you can get a bigger boat!



# I Like Math !

- How do I get the Higher Valuation ?
- Use a Broker !
- Depends on how certain the growth prospects are, whether the investor views 15% as a reasonable return, whether he believes that a 5 times multiple will prevail when HE goes to sell, how badly he wants to buy etc. etc.



# Some Rules of Thumb.

- Here's some rules of thumb which can be handy when trying to figure out what your business is worth.
- Use EBITDA Multiples unless you are sure that you are going to have a major increase in earnings in the next few years.
- Multiply your last year's Earnings before Interest Taxes, and Depreciation by the Multiple.
- Use 3 times for small businesses, 5 times for stable cash positive mid sized companies and 7 – 8 times for very stable (monopoly) or fast growing and profitable businesses.
- Subtract all long term debt, and any short term debt in excess of what is comfortably marginable at your bank.
- If there is some excess asset value (eg. surplus real estate or equipment), add this.
- If there are some future liabilities or off balance sheet liabilities, subtract these.



# Rules Of Thumb

- Before any adjustments, this should give you a pretty good idea of the value of the business.
- Remember the adjustments, pro and con. They can add up.
- I'll leave tax to the experts, but you've got to consider this carefully. You're going to be paying tax on the capital gains of selling the shares of your company.



# Final Thoughts

- Asking the right amount for your business (as approximated above) will prevent people from just walking away, but to actually close a deal requires a full understanding of the business and its prospects, a thorough set of selling documents, playing one buyer against another in an auction process, a good understanding of the capabilities and opportunities for the buyers, understanding and preparing for the due diligence process, expert and detailed negotiations and a flexible seller. Hiring a broker could be the best choice you can make.



# Thank You

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