

VIEWPOINT

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A VALUATION PRIMER

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The first question most business owners ask when we meet with them is: "So what's my business worth?" This Viewpoint helps answer this question by explaining some of the core valuation tools and vocabulary, and by describing the approaches used to estimate a valuation range for a specific business. This valuation primer dovetails with our recent two-part Viewpoint series on "[Creating Value](#)", which discussed the factors that ultimately determine the specific premium buyers are willing to pay for a company.

METHODOLOGY AND VOCABULARY

Let's start with ways to measure value. While various metrics are used, the most common and popular measure is Enterprise Value, or EV for short. This metric looks at the whole value of the company, regardless of which stakeholder is entitled to which piece of the value. In other words, it looks at the value attributable to both the company's debt providers and to the various kinds of equity stockholders. Valuations based on EV are different from valuations based on just the equity value of the company, such as the popular Price/Earnings (P/E) ratios. The benefit of using EV is that it can be more readily compared across companies with different capital structures.

For example, let's look at two competitors of similar size and profitability that have a similar EV. In this case, if the first business has more debt, the value of its equity would automatically be lower. Therefore, if an equity based metric were used, one might erroneously conclude that the first business is fundamentally less valuable than its competitor. Using EV avoids such problems associated with differences in financial leverage.

WHY THIS MATTERS:

- *Knowing business valuation methods helps you understand what drives value for your business.*
- *Understanding the basics helps you ask the right questions of your advisors.*
- *You need to know the vocabulary of valuation if you want to buy/sell a business.*

	TRADING MULTIPLES	M&A MULTIPLES	DISCOUNTED CASH FLOW
Basic approach	Comparison to other companies for which a public market valuation is available	Comparison to other companies for which the acquisition price is known	Value of the future cash flows projected for the company
Benefits	<ul style="list-style-type: none"> Valuation information is readily available Valuation results are typically fairly stable 	<ul style="list-style-type: none"> Best indicator of value for an M&A exit Datapoints usually also available for smaller, privately held companies 	<ul style="list-style-type: none"> Company specific, does not rely on comparison Allows for sensitivity analysis to key assumptions
Drawbacks	<ul style="list-style-type: none"> Typically only available for larger, more mature companies Only a small fraction of comparable companies are typically public 	<ul style="list-style-type: none"> Typically more difficult to find a robust dataset Results can be more volatile (more outliers) 	<ul style="list-style-type: none"> Relies on subjective projections Key components such as terminal value and cost of capital can be perceived as a "black box"

Exhibit 1: Overview of Valuation Methodologies

So how is the EV of a specific business estimated? The three most common methods are trading multiples for public companies, multiples from comparable mergers and acquisitions (M&A) and discounted cash flow (DCF) analysis. These methods are summarized in Exhibit 1.

The trading multiples and M&A multiples approaches both compare the subject company to similar companies for which valuation information is known. In the case of trading multiples, the valuation data is based on stock market data, while in the case of M&A multiples, the valuation data is based on the actual acquisition price paid for the comparison company.

In contrast, the discounted cash flow approach analyzes the specific economics and prospects of the subject company itself, without direct comparison to other businesses. While this method has the benefit of not relying on comparisons, in practice the subjective nature of projections are considered a drawback to the consistency and reliability of this method. However, this method can provide unique insight into the specific value drivers of a business; it also can help analyze the valuation impact of different sets of growth and profitability assumptions.

For start-up companies, two other approaches are sometimes used: financing multiples based on comparable venture financings (conceptually similar to M&A multiples), and asset based methods that value the fixed assets of the business (typically by estimating some replacement cost or liquidation proceeds).

Note that all approaches are used in conjunction to provide an integrated perspective on value. The relevance of each method is driven by a variety of factors, including the stage of company development, the availability of good comparables for any of the multiples approaches, the quality and perceived reliability of financial projections, the strength of the balance sheet and specific industry characteristics.

MORE ON VALUATION MULTIPLES

The most popular valuation "multiples" used for the trading multiples and M&A multiples approaches are EV/Revenues and EV/EBITDA. Revenue multiples are often used because more data points are typically available for this metric; also, they can be applied to companies that are not yet profitable. The downside of this multiple is that it ignores profitability, which is usually considered a critical value driver. In this respect, the EV/EBITDA multiple is superior, though it requires prudent use for companies with low profit margins (which may result in artificially high EV/EBITDA multiples).

Once a sample of relevant valuation multiples is collected (from either comparable public companies or M&A transactions), these multiples can be applied to the financials of the company being valued. For example, if a certain close competitor is trading at an EV/EBITDA of 10x and your EBITDA is \$15MM, then the implied EV is \$150MM. As a business owner, you should be aware that

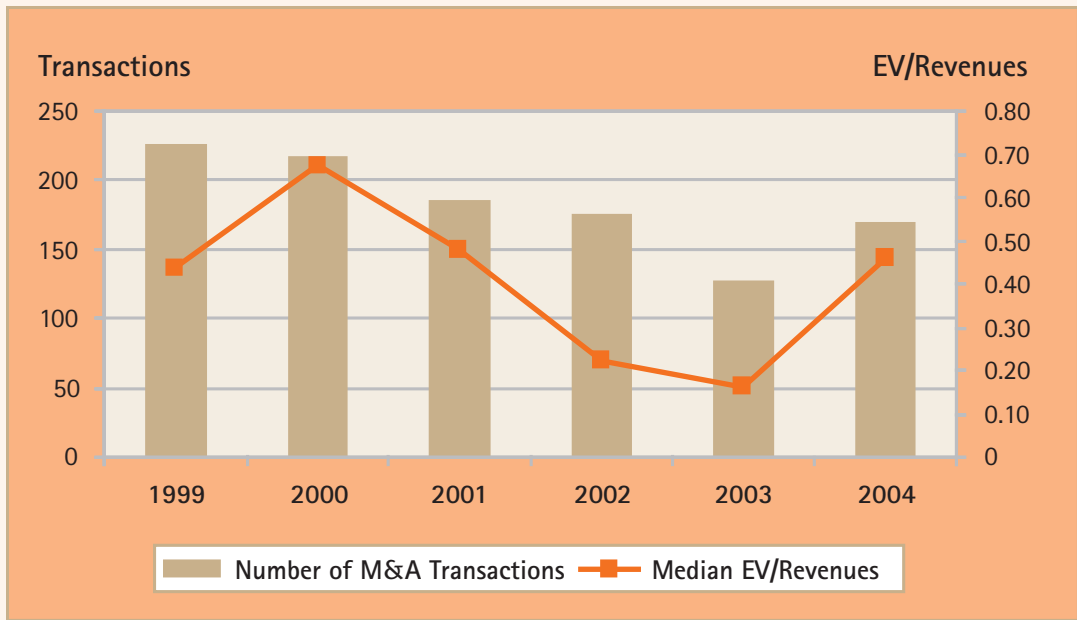


Exhibit 2: Cyclicity in M&A Valuation: Staffing Industry Example

multiples are typically applied to normalized or “restated” numbers that exclude “one-off” items (e.g. windfall profits from the sale of real estate) and items that would not continue if the company were acquired (e.g. country club memberships, luxury car paid for by the company). Appendix A shows numerical examples of applying both the trading multiples and M&A multiples methods.

HIGH-LEVEL DRIVERS OF VALUATION

One of the most important high-level drivers of valuation is the industry in which a company operates. Clearly, a large and rapidly growing market benefits the valuations of all participants. However, other industry dynamics such as competition, asset intensity and level of commoditization also play an important role. As a brief illustration, consider the industrial products, business services, and software segments that Mirus tracks on an ongoing basis ([see Mirus Monitor.](#)) On average, the typically high-growth software companies trade at an EV/EBITDA of about 17x, while more mature and asset intensive industrial companies trade at around 11x.

Another key consideration is market timing. The cyclical nature of industries such as steel, pulp and paper, and semiconductors is well known. Other industries go through the typical development stages where initial rapid expansion is followed by maturation, commoditization, and, ultimately, decline. Still other industries, such as staffing, tend to follow the general economic cycles, as illustrated in Exhibit 2. If

you are looking to sell your business at the best valuation, finding the right point in the cycle is critical. This requires careful balancing between waiting for consolidation to accelerate and exiting before the game of “musical chairs” is over and all key buyers have found seats.

Despite a wide arsenal of valuation methodologies and metrics, no magic formula exists to get to a single “correct” valuation number. The better way to think of valuation is as a probability distribution, as illustrated in Exhibit 3. This exhibit is based on 136 different valuation data points from the trading multiples and M&A multiples methods. As an

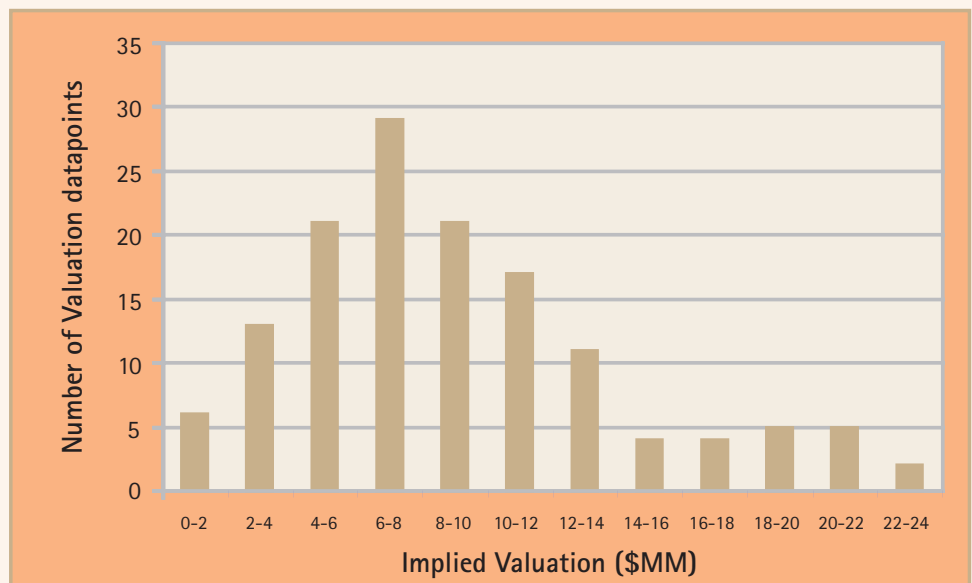


Exhibit 3: Valuation Distribution for a Specific Industrial Products Company

example, the largest bar in this exhibit indicates that 29 out of 136 data points correspond to a valuation of between \$6MM and \$8MM. This suggests that a valuation in the \$6MM to \$8MM range is the most likely from a purely statistical point of view. However, many other data points suggest either higher or lower valuations.

Narrowing down the specific valuation range typically requires a deep understanding of company-specific value drivers, such as those discussed in the March and April 2006 Viewpoints. For example, a company that has patented technology or long-term customer contracts might be worth significantly more than

its peers to a buyer, and fetch closer to \$15 MM.

As investment bankers, we recognize that not everyone enjoys the arcane work involved in applying the valuation methodologies discussed here. But we firmly believe every entrepreneur should possess a working knowledge of the underlying concepts. Knowing how business valuations are done prepares you to ask the right questions of those who are advising you when you're buying or selling a business. Make it your goal to become conversant with this subject so that when it's your time to ask "How much is my business worth?" you'll be prepared to understand the basis for the answer.

Comparable public company:		Comparable acquired company:	
Number of shares outstanding	10,000,000		
Current share price	\$5.25 x	Acquisition price of equity	\$12,500,000
Market capitalization	\$52,500,000		
Add: interest bearing debt	\$12,000,000 +	Add: debt assumed	\$3,000,000 +
Subtract: cash equivalents	\$3,000,000 -	Subtract: cash acquired	\$1,500,000 -
Enterprise Value (EV)	\$61,500,000	Enterprise Value (EV)	\$14,000,000
EBITDA	\$4,800,000 ÷	EBITDA	\$950,000 ÷
EV / EBITDA multiple	12.8	EV / EBITDA multiple	14.7
Subject company:		Subject company:	
EBITDA (restated)	\$2,200	EBITDA (restated)	\$2,200
EV / EBITDA multiple	12.8	EV / EBITDA multiple	14.7
Implied EV	\$28,188	Implied EV	\$32,421

Appendix A: Illustrative Numerical Example. In this example, different enterprise valuation estimates were produced by applying a single public comparable and a single M&A comparable to the same subject company.

Bas van der Brugge, CFA is an associate at Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.

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