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The Essence of Business Valuations



By Ney Grant

Friday, September 21 2007

What is the fundamental value of a business? There are a lot of "rules of thumb" out there for business valuations. Multiples of earnings, multiples of revenue, discounted cash flow, discretionary earnings, earnings before interest, taxes, depreciation and amortization, and so on.

It is easy to get caught up in all of this and lose sight of the overall picture of why we are going to all this trouble. You can often answer complex valuation questions (e.g., what is the value of a patent?) by remembering the bigger picture and applying some common sense. No spreadsheeting required.

Valuation comes down to how much money the business will produce in the future. For larger companies, great effort is placed in modeling the future, then discounting that stream of cash to present-day dollars (two valuation approaches based on this premise are the income approach and the discounted free cash flow approach).

This can be incredibly complex, right down to calculating the discount rate to be used.

Small and midsize companies (companies with earnings of less than \$500,000) also use future earnings. However, since it is too difficult and risky to predict the future, we assume the past will indicate what the future will bring. Thus, when a business broker, a mergers and acquisitions firm, or a business appraiser says you are worth three times your earnings, there is a big assumption that those earnings will continue in the future. Everything is based on that basic assumption.

Here are a couple real-world examples of how earnings impact valuations, based on my own experience:

As president of Compass Point Capital, a business brokerage/M&A firm that helps business owners sell their companies, I once had a large multimillion-dollar deal fall completely apart during due diligence (I was representing the buyer) because we found out that the seller, at close of escrow, was not going to pay off the long-term operating lease on a \$300,000 computer-controlled milling machine. The problem was that the lease payments had been added back to the earnings used to price the business.

I didn't think it was a major issue, and I calmly laid out ways around this problem. The seller could pay off the lease, or we could include the lease payments in the earnings number and recalculate the business price, or we could take the future lease payments and discount them to present-day dollars and use that for a price adjustment. But, I said, we wouldn't "pay for earnings" that don't continue into the future. You see, the price of the business, in this case, was based on three times the historical earnings, but those historical earnings wouldn't continue into the future unless there was no lease payment. We were talking about \$100,000 for the business. The seller was furious and pointed to a document that said that lease payments should be added back to earnings calculations. The seller was plain wrong. The calculations were based

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on the assumption of a payoff of the lease. Unfortunately, that was the end of that deal.

Another example is a client with a combination brick-and-mortar/Web business that had a killer Web URL. After we supplied a business appraisal, he wanted to know why we forgot to value the Web address, as it must be worth "quite a bit." Well, he had had that Web address for years, and thus its earnings-producing potential was already built into past earnings of the business, and therefore was predicting future earnings. In other words, the value was already built-in and there was no additional value. He then said the words I dreaded to hear, "Oh well, then I'll let them have the Web site software, but I'll just keep the Web address." I then had to explain why he couldn't keep the Web address and still charge full value for the business. Those all-important historical earnings include the use of that Web address, and without it, a new buyer could not produce those earnings. In fact, without it, you are not even sure how much revenue and earnings will drop, and the valuation becomes much more complicated.

Remember the basic premise that valuation is really based on future earnings, but because future earnings are too difficult to predict, we use historical earnings; this serves you well as a seller or a buyer. Are you a seller, and your broker used a straight average of historical earnings for your rapidly growing company? Well, a straight average really isn't a predictor of future earnings. Are you a buyer and you see this situation? Good for you. Buy that company.