The Advisor – Winter 2012

Valuation

One of the most critical components of any business acquisition is determining how much the target is worth. A preliminary valuation will form the basis for the buyer's initial offer price.

The common definition of fair market value is "the highest price available in an open and unrestricted market between informed, prudent parties acting at arm's length and under no compulsion to act." The onus is on both parties of an acquisition to calculate what they think the fair market value of the target is to ensure the final price is reasonable and meets both of their objectives.

There are numerous valuation methods one can use to value a target. Discussing the advantages and disadvantages of each method is beyond the scope of this newsletter. Rather, we will focus on the buyer's perspective and an approach he should take when valuing a target.

1. **Focus on the Future Rather than the Past**

   We've all heard the disclaimer "past results do not guarantee future performance". The other famous quote applicable to valuation is "the only thing that is constant is change". There are few industries that are not experiencing rapid changes in technology, competition or regulation. Anticipated changes in the future need to be factored into any business valuation. Focusing on past results will generate an incorrect value.

2. **Challenge and Re-Challenge Assumptions**

   By focusing on the future, a valuator must make numerous assumptions including sales and expense levels, growth rates and the cost of debt and equity. Care must be taken when arriving at these assumptions since a material error in any one of them will result in an erroneous valuation.

3. **Perform Sensitivity Analyses**

   One way to ensure that the assumptions used are reasonable is to test the results by performing numerous "what-if" scenarios. This can easily be done by using a financial model created in Excel or similar spreadsheet software. A valuator can change one or more assumptions while holding the others constant in order to generate best case, worst case and most probable scenarios of what the target is worth.

4. **Focus on Cash Rather than Profits**

   Free cash flow is a better indicator of future economic value than accounting profits. This is due to the numerous rules companies are allowed to use under generally accepted accounting principles. Depending on management's objectives, a company's results can be inflated or reduced based on the accounting policies implemented. Free cash flow eliminates most of these biases.

5. **Use More than One Valuation Method**

   Based on the above, using a discounted cash flow approach as your primary valuation method usually makes the most sense. But it shouldn't be the only one used. Other methods such as trading multiples or transaction multiples of comparable acquisitions should be considered and factored into the final valuation.

6. **Value the Target on a Standalone and Combined Basis**

   One of the main reasons a buyer would consider acquiring a target similar to his business is the belief that the whole is greater than the sum of its parts and synergies will be generated (i.e. 1+1=3). Ideally, a buyer will attempt to acquire a target at a price close to the target's standalone or intrinsic value. A savvy seller will realize that synergies will accrue to the buyer and will want the buyer to pay as much as possible for this synergistic value. By calculating both values, a buyer can establish a range from which a price can be negotiated.

7. **Challenge the Initial Valuation During Due Diligence**

   A price or a price range is usually included in a non-binding letter of intent ("LOI") prepared from the preliminary information provided by the target. Assuming the LOI is agreed upon and signed by the target and detailed due diligence commences, the buyer will then have an opportunity to challenge the assumptions used to calculate the initial valuation. If diligence uncovers evidence that one or more of the assumptions was overly optimistic, it may cause the buyer to reduce the offer price accordingly.

Valuation is more of an art rather than a science. Ultimately, a business is worth whatever a third party is willing to pay for it regardless of what a spreadsheet model generates. But by following the above approach, the buyer stands a better chance of arriving at a value that is defendable, reasonable and agreed to by a potential target.

Aries Advisory Group has significant experience performing business valuations. If you have any business valuation requirements, please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.