Business Valuations

In every business the core objective is sales and the generation of revenue. Companies are born to make money and the sale of product is the sole means for it to do so. While this is readily acknowledged by all, most business leaders would also state that a key objective is to create value, so that one day their company can bring shareholders great rewards through an acquisition or a public offering. To many this objective seems attractive but the concepts surrounding business valuations are unclear and uncertain. This article will serve to clear up some of these vague notions.

Understanding business valuations is a function of grasping how valuations are reached and what elements serve to influence the calculations. In considering valuations it is helpful to understand 5 key concepts. They are:

1. The Source of Business Value – a business derives its value from its assets. Assets include any hard items like machines, computers and similar articles (although they will all be significantly discounted from what you paid), cash on hand, current income, and what is often referred to as market opportunity. The market opportunity element is where the primary negotiations take place as the buyer tries to minimize the potential (for a lower value) and the seller tries to highlight the potential (for a higher value). The market opportunity is the forecasted revenue of the company based on reasonable expectations of the company's future performance.
2. Comparable Sales – the use of comparable sales tries to derive a company's value from the values known to have been assigned to similar companies in the same sector. For example, if Skype just landed $2.6 billion from eBay, it could be argued that a company with a similar product and a similar size user base would also be worth in the area of $2.6 billion. The problem with comparable sales is that no two companies in the same space perform exactly the same, and therefore the par in performance (for better or worse) becomes a focal point for negotiations.
3. Business Value Indicators – there are two aspects of indicators that should be used – intrinsic and extrinsic. The intrinsic indicators are easy to measure and are typically not the focus of negotiations (other than what added value can be placed upon them). Intrinsic indicators include cash flow, market share, brand loyalty and other measurable elements. The extrinsic indicators are bit more open to interpretation (and therefore negotiation) and include elements like sector, competition, location of the business and other elements that are not always subject to subjective measurement.
4. Information Sources – the source of the data being reviewed is critical. Not only does the information have to be credible, but it has to have the ability to claim it has withstood the test of time. In many cases market data, for example, may demonstrate tremendous promise in the future, but show dismal performance in the past. Such a forecast will most likely be largely discounted. The more credible the source, and the most depth the data, the better the chances it can be used as an element in the valuation equation.
5. Financial Forecasts – the presentation of a financial forecast – often called a pro forma (which means "operating as if") – is a necessary procedure, although it can be counted on to be positioned in the best interests of each side. A seller will declare the forecast conservative, while the buyer will claim the same forecast is wildly ambitious. Neither are right, and yet the pro forma exercise is in fact a useful part of the valuation process because it provides the starting point for which the market opportunity and future performance can be agreed upon.

In addition to the 5 key concepts, there are also some rules of the game that should be considered when negotiating a valuation. The negotiations around a valuation are always subjective and always intense, and the better you know the rules (and manipulate them to your benefit), the better the outcome will likely be. There are 6 rules to remember. They are:

1. Use Logic, But Don't Expect it to Always Prevail – Make certain to come to a negotiation prepared to present and defend your positions. If you claims are logical and they can be supported it will be difficult for the other side to sustain a viable challenge. On the other hand, the other side is also preparing a logical and reasonable position that may be exactly opposite your own, and they too have the data and logic to support their claims. Logic, therefore, is in the eye of the beholder and in most circumstances it is the logic of both sides that leads to compromise and the possibility of a mutually satisfactory deal.
2. Strong Negotiators Prevail – always make certain to come prepared by having gathered all the necessary material and by studying it so that you are able to answer all questions quickly and with authority. Also, make certain to know a bit about the other side so that you can raise challenges when the opportunities arise. Study up on negotiation tactics, both so you can deploy them and so you can recognize when the other side is trying to do the same. In the end, the deal goes the way the stronger negotiator wants it.
3. Always Have a Plan – selling or buying a company is a strategic move, meaning that it is executed either when an opportunity consistent with the company's strategic plan presents itself, or it is pursued because the company's strategic plan mandates it. By acting in accordance with a plan, the criteria for the buy or sell will be stable and your objectives will be clear. This will prevent any errors of opportunity that are inconsistent with your overall plans.
4. Money is Made on the Buy – contrary to some popular thought, money is made not when a company is sold, but rather when a company is purchased – meaning that if you buy a company at the right time and for the right price, you will be able to sell later on for a respectable profit. When valuing a company, the price for which it was purchased is not really relevant, although a dramatic or excessive increase may give the new buyer some room for negotiation.
5. There is No Such Thing as Tradition - the traditional value of a company is only useful for historical purposes and may allow a buyer an opportunity to reference the value applications for similar companies in the sector over time. However, tradition is only a guideline for what has typically made sense in a particular sector (because of ROI considerations, customer tends, supply and demand, logistics, etc.). The dynamics of business, and the fluidity of certain sectors in these rapidly changing times, renders quite a bit of tradition meaningless. Determine valuation according to current value, not the restrictions traditional valuations may impose.
6. Pay Attention to Cash Flow – there are plenty of businesses out there with great potential but lack the cash flow needed to sustain operations until the potential is realized. The value of a company is also dependent on its ability to sustain itself, whether current or future (with future sustainability drawing a lower valuation).

Understanding how to value a company is important both for those who seek to sell and those who want to buy. By understanding how a company is valued sellers can take steps to increase the value of their company prior to putting it on the selling block. Similarly, an understanding of value parameters can help a buyer minimize his costs by being able to pinpoint areas that warrant discount. Always subject to negotiation, the

value of a business, like so many things in business and life, is almost completely subjective.