AXIAL FOR CEOS

AXIAL

THE GUIDE TO

PRIVATE COMPANY VALUATION

FORUM

THE SELLER SERIES

Table of Contents

Whether you're ready to sell or not,

every CEO of a growing company wonders about valuation and how it may impact his exit options. Determining the value of a business can be an opaque and somewhat subjective process. It is important as a seller that you understand how to approximate what your business is really worth to both manage your own expectations and help bankers and investors see the value of your company.

Consider this your guide to understanding how private companies are valued by private equity groups (PE) and potential investors. We'll take a look at the two types of acquisitions - platform and add-on - so you'll understand how your company's value can differ based on the views and goals of deal participants. Then, we'll discuss the need for both qualitative and quantitative valuation methods and dive into the most common quantitative models. Finally, we'll give you the tools you need to prepare for valuation discussions and effectively articulate the value of your own company.

Private Company Valuation Methods

There's more than one way to value a company, and no one method is more accurate than another. The valuation exercise starts by utilizing multiple methods to narrow in on a number range. While intuitively it makes sense that all valuation paths lead to the same end result, the reality is that once the numbers have been crunched, a banker is most likely going to end up with a handful of independent, estimated values for a business.

That's where the real work begins. A banker or valuation expert will look carefully at the ranges of valuation that different methods produce and use qualitative, subjective insight to distill a company's various valuation estimates into a single range that makes sense. For each method of valuation, a variety of non-quantitative factors are considered and valuation is adjusted accordingly.

There are three major concepts to understand when it comes to some of the most common valuation methodologies:

1. Discounted Cash Flow

The Discounted Cash Flow (DCF) business valuation model is a powerful tool grounded in a simple concept: the value of any given business is equal to the sum of all future cash flows of that business, discounted to reflect their value today. This valuation is only as good as the assumptions used to create the inputs. There is huge amount of discretion in projecting what a company's business will look like for the next 5-10 years.

When applying the DCF model to a private company, assumptions will be made about that company's cash flow, discount rates, control premiums and illiquidity discounts.

Getting deals done is so much more about the psychology of the stakeholders than actual financials

→ Cash Flow Estimation

Investors and bankers are especially careful when making projections about a private company's cash flow because their history is almost always more obscure than publicly traded companies. Private firms are typically younger, do not face the accounting and information sharing requirements the public firms do, and sometimes do not account for the true cost of running a business. For example, an entrepreneur that founded a private business might work for a below-market wage prior to the sale of the company.

Particularly if you are a younger company, you will have to rely heavily on assumptions and may need to adjust accounting principles for the purposes of this analysis. Idiosyncrasies of small private companies must be included in the cash flow estimations as well. What if the founder will leave after the sale? Does his current salary reflect the true cost of replacing him?

→ Discount Rate Estimation

The discount rate is the rate of return the investor requires from this investment. If he perceives the investment is relatively risky, he will require a higher discount rate.

When valuing public companies it's assumed the investor is properly diversified. This eliminates some of the risk of the investment. With a private company no such assumption can be made. For example, the investor might be a private equity fund specializing in a specific sector and making an investment in that sector.

Discount rates should also typically be higher for a private firm than a public firm because of a difference in expected longevity. With public companies, there's an assumption that the business will continue indefinitely. Smaller private companies with a key founder involved in operations have a shorter expected lifespan.

→ Control Premium & Illiquidity Discount

There are a couple other key items that should be taken into account for a DCF valuation of a private firm. One increases its value (applies a premium), the other decreases it (applies a discount).

The premium derives from control and the value that control can realize. Unlike most purchases of shares in publicly traded firms, the purchase of a private company often comes with a great deal of control over the company. If the business is poorly run and the investor believes he can improve financial performance by exercising their power to change management, there will be a significant **control premium**.

While the transaction costs to buy and sell shares in a public firm are virtually nil; the resources and time required to buy and sell a private company are significant. The DCF valuation should account for these costs. This **illiquidity discount** is widely attributed for the 20% to 30% price discount sales of private companies exhibit relative to sales of public companies with comparable financial performance.

DCF valuations can be a powerful tool if used properly, but also have serious limitations. We discussed above the difficulty of properly estimating cash flows from a private company. Estimating a trustworthy discount rate is not an easy matter either.

These issues are compounded because tiny changes to the inputs of a DCF valuation can have big effects. Discounted cash flow models often assume a business will operate for a long or infinite period of time. A tiny change in the growth rates of cash flows or discount rate can cause a huge swing in value.

Most buyers, as they start to negotiate with you, are going to attack many of the assumptions made about future growth. Help your banker understand which line items are highly predictable and which you believe are more variable. You'll be able to get a better valuation for your business and help them in negotiation with a buyer.

The only true measure of your company's worth is whatever someone is willing to pay for it.

2. Trading Comparables

Bankers typically love using trading comp multiples to determine valuation because they reflect real-time, real-world valuation data. Trading comp valuations determine the current value of a company using a sample of ratios from a comparable peer group of publicly traded companies.

The key consideration here is to make sure you have the right universe of peer companies – companies that are the closest reflection to you in terms of size, product mix, growth potential, etc. Bankers will ideally look at a peer group of somewhere between 5-15 businesses. Rather than simply looking at the group average, a smart banker will focus on the companies that look most like your business and consider these companies' multiples more heavily than the group's average.

Helping your banker understand the key differences between the peer group and your firm can help him or her understand which companies are most relevant and will have the biggest impact on the valuation of your business.

3. Transaction Comparables

Comparable transactions considers the past sales of similar companies as well as the market value of publicly traded firms that have an equivalent business model to the company being valued.

This is hit-or-miss as a method for reliable valuation. The challenge is that there are likely a limited number (if any) of truly comparable transactions for a banker to consider. Assuming a banker is able to compile a list of transactions that make sense, the data surrounding the transaction (such as purchase price) is rarely publicly available. When it is, a banker isn't going to know what portion of the price paid was standalone valuation and what portion was attributable to other factors (synergies, control premiums, etc.).

Finally, recency matters – market conditions, industries, etc. change. So, depending on what's available, transaction comps can run the gamut from being virtually ignored in a valuation process to being a lynchpin in a negotiation of value.

Helping A Banker Understand Your Company

Often, as an industry insider, you'll have information about recent company acquisitions that your banker isn't aware of or doesn't know much about. By filling him in with as many details as possible, he can build a more realistic model for your business.

No valuation method will ever truly account for all the unique attributes and idiosyncrasies of a business. The best a banker can do is account for as many variables as possible and settle on a range that makes the most sense. By staying involved in the process and providing information your banker may not have access to you can ensure you're getting the most realistic valuation range.

And, though your banker is going to do their best analysis to predict an accurate valuation range for your company, remember that valuation is never perfect and that the only true way to find out the value of your business at any given point in time is to approach the market of potential buyers completely comprehensively with an excellent presentation of your business. That is the one final say on your company's valuation — the price that the market of buyers is willing to pay.

Valuing Add-Ons vs. Platforms

When selling to private equity firms, businesses are acquired as either platform companies or add-ons. Valuation depends on the goals and strategic plans of the buyer.

We'll discuss valuation methods in more detail in the next section, but the techniques used for platforms and add-ons are the same. The difference comes in the art of estimation. Your banker will have to make projections about things like cash flow, costs, sales of similar companies, etc. Read on to understand how to most deftly articulate your value to bankers and buyers because at the end of the day, the only true measure of your company's worth is whatever someone is willing to pay for it.

Example: Whole Foods

As an example, the platform acquisition of Whole Foods by retail private equity firm, Leonard Green & Partners, has rolled in a number of smaller add-ons, including independent grocers, a coffee maker, a vitamin brand and others. These add-ons leverage the advantages of the platform and create synergies that help increase the sales penetration and/or decrease the operating costs for other add-ons. These synergies make both the platform and the add-ons more valuable.

PLATFORM ACQUISITIONS

Platform Investments typically include companies in high-growth industries that command significant market share. They often are well managed, are reasonably capitalized and have broad distribution and market exposure. These companies likely have multiple avenues of growth and clear opportunities to leverage their position in the market. They typically command a premium price when sold.

VS.

ADD-ON ACQUISITION

Add-ons Companies often aren't viewed as industry leaders and might suffer from issues with management, undercapitalization, lack of broad distribution or limited exposure to their industry. Buyers of add-ons are much more focused on the strategic and financial benefits of adding to an existing portfolio company. The strategy is clearly defined so the company can be narrower in focus and growth potential.

BENEFITS & DRAWBACKS OF ADD-ON ACQUISITIONS

Is there a simple formula for choosing the right valuation for a platform or add-on? No. Is it better to be acquired as a platform or add-on? It's situational. Platforms traditionally command a premium. But the right add-ons, though they might be smaller, may negotiate similar, higher multiples in the right circumstances.

When considering add-ons, bankers often weigh the following potential benefits and drawbacks:

Benefits

- lowering costs by merging sales staffs
- expanding sales into regions
- increasing product offerings
- cross-selling/upselling opportunities
- eliminating duplicate management
- consolidating financial functions
- eliminating idle manufacturing capacity
- boosting buying power

Drawbacks

- lack of sales distribution
- management gaps
- IT fragmentation
- less detailed accounting, understanding of cost structure
- HR costs, eg merging benefit platforms
- costs of merging operational logistics

Source: **Rick Schmitt** , AccuVal-LiquiTec

Valuation & The Art of Negotiating

Competition sets the price for private companies coming to market. With growth in the M&A market and more prominent companies entering the playing field, there's no doubt we'll see more deal making — sometimes with hefty multiples paid — for major platforms. In June 2014, the aluminum company Alcoa announced a nearly $3 billion acquisition of Firth Rixson (owned by Oak Hill Capital Partners), a manufacturer of jet components, attempting to increase its presence in the aerospace market. This is just one of numerous examples of the widespread desire to expand market share and how companies do this by making meaningful acquisitions.

Valuing add-ons gets more complex, particularly when private equity firms need to put capital to work and grow acquisition categories. They're able to offer higher prices, in terms of EBITDA multiples, but that doesn't always mean they will.

Put it into practice

Imagine a lower-middle market grocer. As a standalone company, let's say the business, which generates $6 million of EBITDA when considering all of its standalone benefits and issues, might receive a 5x EBITDA multiple, or a $30 million valuation. However, let's say the prospective private equity buyer plans to roll up this company into a larger platform, so when considering the combined, projected EBITDA, that's now $8 million. This might result in a sale that appears to be a multiple of eight times current EBITDA, increasing the value based on the trailing EBITDA and market perception of value by 33%.

This is where negotiating skills come into play. If there's competition to buy this grocer, then the private equity firm might be forced to pay a higher multiple relative to recent transactions for similar stand-alone businesses. This converts some roll-up synergies of the buyer back to the seller, and puts more pressure on the private equity firm to intrinsically grow post-acquisition to justify the premium.

If the private equity firm chooses to pass on the deal due to the seller's request for a higher valuation, then this might mean the benefits of synergy of this potential acquisition will accrue to another private equity firm that elects to complete the transaction. Ultimately, the fit with the platform and opportunity for synergistic growth are key factors in negotiating final value.

Where are the opportunities? *Industries considered "recession-proof" command heavy interest, for example: oil and gas, medical and pharmaceutical, food, software.*

Pre and Post Money Valuation

The **pre-money valuation** of a company is simply the value of the company before an equity investment is made. The **post-money valuation** is the pre-money valuation plus the equity investment. The difference can be critical as a business scales and receives new investors.

Do the Math:

Suppose you and a partner start a company. You issue 1,000,000 shares of stock and divide the equally between you and your partner. After some initial success, you decide you need additional capital. An investor is willing to invest $5 million at a post-money valuation of $15 million, giving an implied pre-money valuation of $10 million. So, before you receive the investment, the original shares are worth:

$$\frac{\text{Pre-Money Valuation}}{\text{\# shares outstanding}} \rightarrow \frac{\$10{,}000{,}000}{1{,}000{,}000} = \$10 \text{ per share}$$

To complete the transaction, you issue new shares to the investor. For the $5 million investment, the investor receives:

$$\frac{\text{Investment}}{\text{Pre-Money Price Per Share}} \rightarrow \frac{\$5{,}000{,}000}{\$10} = 500{,}000 \text{ shares}$$

Now there are 1,500,000 shares outstanding. You and your partner own the original 1,000,000 shares representing 67% of the company.

The company continues to grow. It's not long before you need additional capital. A new investor is now willing to invest $10 million at a post-money valuation of $30 million, giving an implied pre-money valuation of $20 million. Notice that the investor is willing to give a premium to the previous round - nice work!

Using the same calculations, each share is worth $13.33 before the investment ($20,000,000 / 1,500,000) and the company will issue 750,000 new shares ($10,000,000 / $13.33) to this latest investor. Following this transaction, there are 2,250,000 shares outstanding with the 1,000,000 owned by you and your partner representing 44% of the company.

Each round of capital raised reduces (dilutes) your ownership stake in the company. Each time you raise capital, however, the value of each of your shares gets higher and higher. The outside investors from early rounds are also subject to dilution at each subsequent round of funding.

Help Investors See the Value of Your Company

To identify the best buyer and maximize purchase price you and your banker should both be able to articulate your company's value drivers. Clearly articulating these points will help a potential investor see the value of your business.

First and foremost, you have to succinctly be able to tell someone how the company makes money. Too often, write-ups or pitch books of a business do not explain how the business makes money. You must be able to answer that question.

There are five key value drivers that should be discussed as early as possible in the sell process to ensure all parties are on the same page:

1. **Customers.** One of the most important value drivers to discuss is your customer. An understanding of who its customers are is essential for any private equity firm and deal negotiation. You have to be able to speak to how you acquire customers. What is the profile and size of your customer base? How do you engage with them? Having an organized CRM and legitimate salesforce, while not necessary for a successful deal, can help demonstrate to an interested private equity firm that you are working with regular, sustainable customers.

   You also have to be able to speak to how you lose customers. If your customers are able to abandon your business overnight with little to no switching costs, it will be a red flag for many private equity firms. If you have customers that can leave next week without pain and heartburn, that's not a good thing. While it is not an insurmountable challenge, the deeper entrenched your business is in the customer's life and business, the better.

2. **Industry & End Markets.** In addition to your customers, it is imperative to be able to comment on the size of addressable market. There is no need for detailed reports, but you must have a sense of the number of potential customers and trends in that space. Is your industry growing or shrinking? Is there heavy regulation? These types of extra-company factors can make realizing a successful investment difficult for most private equity shops.

Private equity investors are also concerned about businesses that are highly discretionary. For example, if your business offers a completely discretionary item, that means the purchase can be put off during downturns and economic uncertainty. That is a big risk in future cash flows and, unsurprisingly, a red flag for many PE investors. Similarly, if a business is very cyclical, it can be challenging for an investor. Most PE firms use some form of leverage during an acquisition, and leverage and cyclicality is a very risky cocktail. It can go sideways on you very quickly.

To help assuage an investor's concerns, demonstrate that your business tracks along with the general economy. If you can show solid financials from 2007-2010, that is a great sign that your business is not particularly subject to cyclicality or customer discretion.

3. **Suppliers.** The two questions you need to address in relation to suppliers are: **Are there any supplier concentrations?** If your business is being influenced by your supplier because of their consolidation or control of the market, that is not a deal killer, but it is something that must be disclosed to the private equity firm as soon as possible.

   Can a supplier go straight to your customer? If that is the case, it makes investors very nervous. Most private equity investors want to see a fundamental, tangible reason why your business exists. You need to demonstrate that your firm will be around for a long time because it is addressing a clear need — and one that no one else can easily replicate.

4. **Competition.** As the interested investor gets the lay of the land, he will also need to know about the level and type of competition surrounding your company. You will need to effectively be able to address the presence of any competitors and articulate how you differ from them. What are the variables? Price? Service? Location?

   If there is no competition, then you still need to explain why the customer is buying from you. Are they buying because of the salesperson? Or because of the right price? It may sound like a silly question, but it is fundamental to why a company exists. The better you can answer the question, the more value you can demonstrate in your business.

5. **Management & Financials.** Only after understanding the full ecosystem in which your company exists will the investor begin to look into the company itself. Understanding the key stakeholders and management of the business is absolutely crucial to a successful deal.

   Getting deals done in the lower middle market is so much more about the psychology of the stakeholders than actual financials. You need to make sure everybody is happy. This is why most private equity firms will spend so much time getting to know the management team and making sure there is a fit. If you try and fit everyone into a predetermined box or equation, the deal will fail.

   When it comes to financials, the numbers will be what they will be. At this stage of the process, the investor is probably most interested in seeing how your business is organized. The numbers need to be reliable. Private equity buyers don't want to be in a situation where they've made a deal, only to discover during due diligence that they were misled. The more investors feel in your ability to track numbers, the more confident they will feel about the deal.