DETERMINING A COMPANY'S VALUE

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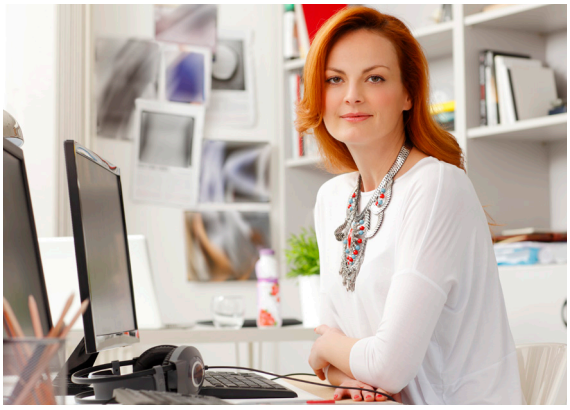
M&T Bank

"WHAT'S THE VALUE OF MY COMPANY?"

It's a question that we're constantly fielding from entrepreneurs operating companies of varying sizes across a broad range of industries. They frequently expect a formula-driven answer, failing to appreciate the breadth of valuation methods, the limitations of each approach, and the judgments required to integrate the various analyses. Great businesses are built through smarts and hard work, yet some owners shortchange themselves when they are looking to sell their company. They don't do the last bit of hard work—a multi-faceted valuation—to empower themselves for discussions with potential buyers. It turns out that answering a seemingly simple question can be anything but simple.



KNOWING YOUR NUMBER

As we kick off an initial meeting, many business owners will quickly inform us that they "know their multiple." This isn't surprising. Whether they're referencing an Enterprise Value-to-EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) multiple or an industry-specific multiple (an example being the Enterprise Value-to-Subscriber multiple used in the cable TV industry), owners understand this approach. It's an easy way to think about valuation that ties in nicely with observable data points at publicly traded companies.

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While comparable public company analysis is appealing due to the abundance of easily obtained information, it is rarely straightforward. Many years ago, we met with a small regional brewer who likened their business to Anheuser-Busch. Although both companies produced beer, the similarities ended there. Setting aside the drastic difference in business size, Anheuser-Busch was operating a broadly diversified business with snack food, amusement park, and aluminum recycling segments beyond its core brewing activities. Applying Anheuser-Busch's EBITDA multiple to the client company made no sense. Finding truly comparable public brewers and discounting those multiples to account for differing business sizes were key steps in getting to a realistic multiple.

Operational comparability and relative business scale remain important when shifting the valuation focus to precedent transaction analysis. Consider a recent example: Is it realistic for a local grocery chain to expect the same multiple that Whole Foods received from Amazon? The business models and scales differ significantly—and so should the multiples. The local grocer needs information on values paid for companies of comparable scope and size to understand his company's realistic multiple. As professional advisors, we favor this analysis because it reflects the real world. But, even with specialized databases and proprietary tools, obtaining relevant information can be difficult as the vast majority of company sales are private with limited disclosure about multiples.

If multiple-based analyses depend upon information, what happens when data is scarce or the subject company isn't generating meaningful earnings? We've recently encountered this precise situation at a business that has developed a groundbreaking medical device with worldwide potential. With no comparable companies or transactions and no current earnings, we're relying on discounted cash flow ("DCF") analysis to value the business—something easier said than done.

INGREDIENTS FOR VALUATION SUCCESS

The three key ingredients of a DCF valuation are clear-cut: a multi-year cash flow projection, a future estimate of the company's value, and an appropriate discount rate to bring each estimate back to today's dollars. The pieces of the analysis are well-established. The debates over each piece are equally consistent—Are the projections credible / achievable? Is the future value realistic? Does the discount rate adequately reflect the business risk? Smart, experienced people can differ significantly on each question and slight variations of opinion can yield dramatically different valuations. With so many subjective moving parts, M&A professionals typically look first to concrete market observations identified with the multiple-based methods. This doesn't mean that DCF valuation is entirely dismissed with mature, profitable companies. Instead, it is used to complement or confirm the market-based multiples.

For an established company, a completed DCF valuation provides the building blocks for Leveraged Buyout ("LBO") analysis. Using the financial projections and anticipated exit value from the DCF valuation, LBO analysis examines the interplay of different capital structures and equity return requirements to estimate a valuation range for the business. On the surface, this method can spark the same debates as a DCF analysis but, an active, observable market for capital structures and return expectations enables a trained professional to develop a defensible valuation.

Considering the income statement bias of the foregoing methods, a basic question should be asked – "what are the fair market values of the company's assets?" While this

approach isn't likely to drive the overall valuation, it can still have a meaningful impact. Once, we were advising a manufacturer located near London's Heathrow Airport. The balance sheet recorded the company's land at its 30-year old purchase cost, but Heathrow's expansion had driven skyrocketing land values – a fact overlooked in other valuation methods. In short, a careful balance sheet examination significantly affected the company's valuation.

In bringing the various valuations together, many business owners expect a level of "agreement" among the different methods. Sometimes, that's true. In other cases, results can vary widely. The key is properly weighting each method and understanding how they complement each other to arrive at an integrated opinion of value. Of course, the truest test of valuation is the price a third party is willing to pay in a purchase transaction. Even with all of this analysis, the range of bids submitted by various investors can still take us by surprise. The real world is messy, complicated and challenging – why would business valuation be any different?

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