valuation

Key Financial Concepts (III) - Understanding common ways of valuing your business

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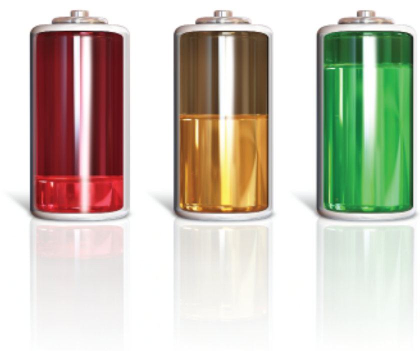

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In brief

Valuation is a much-debated area of finance. Frankly, you can come up with any number of valuation techniques and produce a value for a business that can vary by hundreds of percent.

The simplest and easiest to apply is a so-called multiple. In its simplest terms, it is a number by which you multiply income in order to get a value. If a business earns $1m in income and you apply a multiple of 10, the valuation is $10m. The questions are, what figure do you use for income, and what figure do you use for the multiple?

The first depends on your purpose, coupled with the extent to which you control the business. Are you a sole owner, a small shareholder, a potential partner or possibly looking to acquire the business or for that matter, be acquired. Those issues will decide what line in the profit and loss account you want to use as income.

The multiple is generally a number that reflects prevailing conditions in your industry. In the stock market, you might see double digit multiples for the prices of shares in companies with strong growth prospects – the idea being that if they achieve that growth, the multiple will eventually fall into line with the general market. Alternatively, a company with a poor outlook could trade on a low single-digit multiple.

But remember, there is nothing complicated about all this. As you will see in the next few pages, the income figure is just a matter of choosing the appropriate line on the P&L. The multiple is usually determined by the marketplace.

Terminology is straightforward

Acronyms mean what they say

People can glaze over when they hear a term like EBITDA. It means exactly what it says: Earnings Before you have deducted Interest, Tax, Depreciation and Amortisation. It is toward the top of the Profit & Loss account before most other expense have been deducted. If you want to get to EBIT (Earnings Before Interest and Tax), you simple deduct the DA (Depreciation and Amortisation). That takes you lower down the P&L. Deduct I (interest) next and you'll get EBT (Earnings Before Tax). Deduct the T (Tax) and you get the bottom line: Net Income. It's as simple as that.

EBITDA → **EBITDA - DA = EBIT** → **EBIT - I = EBT** → **EBT - T = Net Income**

On the next page, these are shown as they would appear on a sample profit and loss statement.

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Simplified Income Statement

ITEM	AMOUNT
Operating Revenue	4,600,600
Operating Expenses	- 2,850,000
EBITDA	**1,750,000**
Depreciation & Amortisation	- 450,000
EBIT	**1,300,000**
Net Interest Expense or Income	- 100,000
EBT	**1,200,000**
Tax	- 200,000
Net Income	**1,000,000**

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Which lines to use

The two most common "incomes"

EBITDA	If you are in control of the firm, or are looking to buy it, EBITDA is often the crucial line because you are able to manage the lines below it. It shows how much cash the business is generating and therefore how much debt it can support. In our example, it is generating $1.75m. If it could borrow money at 10% interest, it could support $17.5m in debt.
Net Income	If you are a small shareholder in a public company, you have no management control, therefore it is only the bottom line that you can value. That is why stock market analysis most commonly refer to the PE, ie, what does the price represent as a multiple of net earnings. If the firm in our example has 1m shares, then each share is earning $1. If the shares trade for $10, they are on a multiple of 10X.

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Using multiples

What's the point?

Multiples are a quick and easy reference for targeting your business plans. Rather than simply plan for your growth in terms of turnover and profits, look at what value you will create over time.

Different revenue streams command different multiples. If you plan to have a business that in five years time will generate good recurrent income coupled with good growth prospects, then use a multiple to estimate what you think it could be worth.

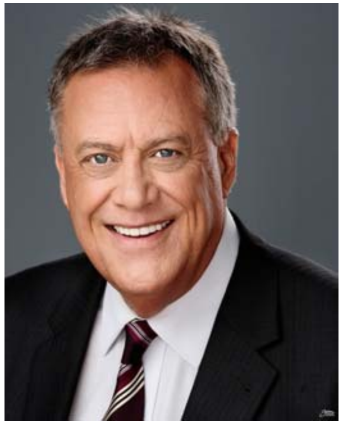
Make that your goal. Think through your desired financial profile. You will be in charge of your depreciation and tax policies. You will decide the level of gearing. You will drive decisions to invest in new assets or divest others. You can decide what financial metrics you want to have when it might be time to grow – by taking over another business, or merging with another firm, or be taken over, or simply selling out and moving on.

Debate will continue about the appropriate figures to use in valuation multiples, but they remain the simplest shorthand reference point to monitor how much value you are going to create.

For more information, visit my website www.alanhargreaves.com

Hi, I'm Alan Hargreaves. I specialise in simplifying complex business problems. In over 35 years as a business executive, I have never found an issue that cannot be addressed through identifying the essential but simple steps required to make any problem manageable. It might be your career, your firm, your team or your strategy. It doesn't matter. All hurdles can be lowered through dispassionate analysis, and all executives can embrace simple processes to take them forward.

Using these techniques, I have helped hundreds of people through the various stages of their business or career development. It may be the challenge of taking on new responsibilities; it could be the task of managing a business you have created yourself; it may be handling a difficult team in the midst of major change. I use a straightforward combination of key principles to get results: collaboration, adaptation, simplification and action. You can contact me anytime at alan@alanhargreaves.com.



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