Private Company Valuation Techniques

Valuation is a process used to determine what a business is worth. Determining a private company's worth and knowing what drives its value is a prerequisite for deciding on the appropriate price to pay or receive in an acquisition, merger transaction, corporate restructuring, sale of securities, and other taxable events. Private companies may include small family-owned enterprises, divisions/subsidiaries of larger private companies, or large corporations.

Many of the same techniques used to value public companies can be used to value private companies as well. Nevertheless, finding the true intrinsic value of a private company is a tricky task. It entails a set of calculations and assumptions based on industry-wide and company specific statistics. It includes key planning, adjusting of financial statements and applying the appropriate business valuation methodology. Unfortunately, there are several factors that influence the valuation, which include size, lack of operational history, management and operational control, difficulty quantifying earnings and cash flow, capital structure, and risk in the business.

Of the numerous acceptable valuation methods, each will yield a different result based on the sensitivity of inputs. In addition, there are certain modifications necessary to adjust for the private status of the private company. The cost of capital for private companies is different since they do not have access to capital via equity markets. The key to establishing a starting point for any private company valuation is to determine the type of the company involved, whether it is a private or a publicly traded company, and its appropriate industry.

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Though often smaller in size and less financially transparent than their publicly traded peers, private companies have a major importance in the world's economy. Among the +150,000 firms operating in United States that generate greater than $10 million in annual revenues, roughly 90% are privately-held companies. A privately-held company is owned either by non-governmental organizations or by less than 300 shareholders so as not to require reporting with the Securities and Exchanges Commission. The private company's owners do not publicly issue or trade shares of the private company, instead they keep ownership and associated transactions discreet.

Valuation of such closely-held private companies can be expensive and difficult due to a lack of exact financial information. Although it may be difficult to research private companies, it is not impossible. There are methodologies and financial tools available to assist in making reasonable estimates of a private company's value. With an estimated value and a good intuition, one can arrive at a reasonable range of a private company's intrinsic value.

Factors Influencing Private Company Valuation

Private company valuation is not an entirely objective matter. Subjective estimates, influenced by motivations and incentives, may alter valuation outcomes. One might need to value a private company for the following reasons:

- **To sell it**
- **To raise capital from investors**
- **As part of a divorce settlement**
- **For a management buyout**
- **For estate planning**
- **For an employee stock ownership plan (ESOP)**
- **For taxation purposes**

Other factors that may influence a private company's valuation are its size, operating history, management and operational control, quantification of earnings and cash flow, capital structure, business risk, and breadth of liquidity in the market for private company's stock.

- **Lack of Market Liquidity**—The lack of liquidity discounts the value of a private company by as much as 50% since there is no benchmark for valuing private companies on a daily basis as with a publicly traded exchange. Most commonly, a liquidity discount of 20-30% is applied. There are many factors that go into determining the discount factor in a private valuation including size, operating history, quality of earnings/cash flows, management, industry profile, and business risks.

- **Size**—Privately-held companies are generally much smaller than their publicly-traded comparables. Small private companies may be good acquisition targets for larger competitors and publicly-traded counterparts.

  Size contributes to the discount of the valuation since it reflects the industry. Small industries may not be as attractive or may have undesirable growth rates, which could negatively influence the valuation multiple. Smaller-sized businesses also have considerably more risk than larger ones.

- **Operating History**—Operating history is important to determine a track record for revenue growth, profitability and earnings growth. The less operating history a private company has the greater the risk for inconsistent cash flows, which leads to a greater valuation discount.

- **Business Mix**—Depending on whether a private company operates within a niche or has a variety of product mixes can impact the valuation discount. Market share and product concentration add to business risk.

- **Management Control**—Private companies have a very small pool of shareholders that often act as managers. This limits the pool of talent that runs the private company. In addition there may be no succession plan placing the business in considerable risk if the principal manager is no longer able to work. Finally, family controlled enterprises may have considerable internal conflict over the operational control. These risks lead to increased valuation discount.

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- **Earnings Measurement**—Although public companies are managed to maximize earnings on a quarterly basis, private companies may be managed for tax minimization, long term growth, or cash flow. Different operational motives make it difficult to measure true earnings and cash flows of the private company. It is important to normalize financials when trying to value a private company to determine what the private company would be earning if it was operated like a public company.

- **Capital Structure**—Private companies, unlike public companies, do not have as broad of an access to capital and therefore are unable to be as selective of their funding sources. Public companies are able to choose from both equity and debt sources to minimize their cost of capital while private companies are primarily dependent on bank loans, which are relatively expensive and weaken the balance sheet, or internal cash flows.

- **Risk**—Private companies are generally riskier than their public comparables, often due to:
  - *Internal Criteria*—Private Companies tend to be smaller in size and may lack a demonstrable financial track record.
  - *External Criteria*—May face risk of business concentration or may be competing in an expansive industry.

Valuation of Private vs. Public Companies

Private company valuations are discounted based on several risk factors associated with private sector investing, which results in a marked difference between the valuation of a privately held company, subsidiary or a division and a publicly traded corporation. There are number of distinctions between private and public companies that have an impact on the private company's value. An accurate valuation of privately owned companies largely depends on availability and reliability of the private company's historic financial information. Public company financial statements are officially audited, documented and overseen by a government regulator. Alternatively, private firms do not have government oversight unless operating in a regulated industry and usually audited financial statements are not required.

Moreover, private companies may manage their operations for different purposes than profit. Managers of private firms often prepare their financial statements to minimize profits and, therefore, taxes. Alternatively, managers of public firms tend to want higher profits to increase their stock price. As a result, a firm's historic financial information may not be accurate and can lead to over- and undervaluation. In an acquisition, a buyer often performs due diligence to verify the seller's information. When analysts put a value on a particular private company, privately held companies are often valued lower than their public counterparts. The lower value is attributed to the fact that there is no liquid market for the private company's stock. Such discounts are accounted for during valuation.

Private Company Valuation Methodologies

Since private companies may manage their balance sheets and earnings for alternative purposes, discounted cash flow analysis or comparable valuation techniques require additional research. Earnings and capital structure might need to be reorganized or modified accordingly. When it comes to private companies, some nontraditional valuation techniques may be appropriate such as analysis of invested capital, replacement cost, asset appraisal and capitalization of earnings.

As discussed earlier, there are several methods for estimating the value of a particular private company. When it comes to private companies, the following three techniques are most commonly used:

1. **Comparable Company Trading Multiple Analysis (also known as "peer group analysis", "equity comps", "trading comps", and "public comps")**
2. **Precedent/Comparable Transaction Analysis (also known as "transaction comps" and "deal comps")**
3. **Discounted Cash Flow ("DCF") Analysis**

Other Valuation Methodologies Include:

1. **Break-up Analysis**
2. **Asset Valuation**
3. **Analysis of Invested Capital/Replacement Cost**
4. **Leveraged Buyout (LBO) Analysis**

Comparable Private Company Trading Multiple Analysis (Public Comps)

Comparable company trading multiples analysis or trading comps uses the valuation multiples of similar or comparable publicly-traded companies to value a target private company. Peers can be grouped based on any number of criteria, such as industry focus, private company size, or growth. The multiples can be Enterprise Value (EV) based multiples like EV/Sales, EV/EBITDA or EV/EBIT, and Equity based multiples like Price to Earnings (P/E). The multiples derived from this type of analysis are at a given point in time and generally change over time. It is important to note that trading multiples do not reflect control premiums or potential synergies. Generally, the following steps are applied to compare your target private company to a similar public company:

1. **Compile and select the list of comparable companies**

   To select the comparable universe or peer group for a given private company target, one must understand the target private company's business to ensure that its peers share similar industry, business, and financial characteristics with the target. Among the few suitable sources that can provide insight in identifying accurate public comparables are annual reports or 10-K (especially the section on competition), the public companies' prospectus, SIC code lookup, and PrivCo's private company reports.

   Once you have identified the comparable universe, the next step is to gather all necessary information for each peer company, usually from 10-K, 10-Q, and/or 8-K

earnings press release, consensus financial projections or a recent analyst research report with financial projections.

2. **Calculate relevant financials and multiples**

Making pro forma adjustments to a comparable company's financial statements is often the trickiest part. It requires normalizing the financials to adjust for one-time / non-recurring items that temporarily distort earnings. Income statement items (denominator) should be adjusted for one-time or non-recurring items. For the valuation purposes, non-recurring items should not be included in financials (e.g. P&L statements, EBIT, EBITDA, Net income, etc).

After selecting a universe of comparable companies, create a list of ratios and values you want to compare. These can include price, shares outstanding or market capitalization, earnings per share (EPS), growth rate (five-year), price-to-earnings ratio (P/E), price-to-sales ratio (P/S), EV (enterprise value), EBITDA (earnings before interest taxes, depreciation and amortization), etc.

Next step is to calculate multiples. Multiples are the heart of the comparable companies analysis as it is hinged on both the comparable company's risk profile and operating performance. Multiples that are used should be relative to the industry and appropriate in relating the public and private companies.

Equity Multiples—Certain flows apply to equity holders only, like net income and book value of equity. The balance sheet and income statement values utilized are after discretionary debt payments. Hence, equity multiples are used to derive an implied equity value. *Relevant multiples:*

- o   Price/Earnings (market equity value / net income to common shareholders)
- o   Price/Book (market equity value / book value of equity)
- o   Price/Cash Flow (market equity value / after-tax cash flow)
- o   PEG Ratio—measures growth prospects (PE Ratio / Annual EPS Growth)

Enterprise multiples—Other flows apply to all capital providers (debt & equity). The balance sheet and income statement values utilized are before the effects of discretionary debt payments. Hence, enterprise multiples are used to derive an implied enterprise value. Relevant multiples:

- o   Enterprise value/Sales
- o   Enterprise value/EBITDA
- o   Enterprise value/EBIT

It is best to compare several multiples during the analysis to determine which one(s) the market uses to value the universe of comparable private companies.

3. **Apply valuation and analyze the results**

Finally after calculating relevant multiples, one must determine implied valuation ranges. To compare comparable private companies effectively, one must understand why their multiples are different. Reasons why one private company's projected

EV/EBITDA multiple might be lower than that of a peer could include slower projected growth, declining margins, or a higher risk profile. For example, performing a comparable company analysis is an art, not a science. It's important to pay careful attention to the selection of comps, how one spreads the financial for each private company, and selection of favourable multiples.

4. **Apply a private company discount, if applicable**

It is not merely enough to simply use the same multiple as that of another publicly traded company. In most, if not all cases, the multiples that the "comps" universe is trading at must be subjectively adjusted as public companies will typically receive higher valuations than their privately held peers due to a lack of liquidity and the potential restructuring or accounting reorganization challenges that may arise in the event of an exit. Valuation discounts for liquidity should be applied to the private company that best reflects the target private company's risk and often ranges from 20-30%.

A major disadvantage of this valuation method is that it is often difficult to determine the right comparable private companies. Very rarely does one find two identical private companies. Hence, adjustments should be made to reflect differences, such as business mix, geographic spread and capital structure.

Comparable Transaction Analysis (Deal Comps)

Comparable transactions analysis or analysis of selected acquisitions is very similar to trading comps except deal comps utilize actual transaction multiples instead of trading multiples from the universe of comparable private companies. The analysis uses multiples and premiums paid in comparable transactions to value target private companies. When using this approach to value private companies, transactions should have relevant attributes:

- **Industry group**
- **Timing - Transactions should be recent (typically no more than five years)**
- **Business mix (products, markets served, distribution channels, etc.)**
- **Geographic location**
- **Size (revenues, assets, market cap)**

The process of compiling deal comps is similar to assembling trading comps, but data can be more difficult to locate. Sources of information for public deals include internal firm resources, press releases, SIC/NAICS code screen, 8-K's, Proxy's and other SEC filings.

The major disadvantage of this method is the only commonly available metric is sales, and value is not always clearly tied to sales or even profit. Moreover, precedent transactions are rarely directly comparable. Every transaction has its own set of unique circumstances and not all aspects of a transaction can be captured using valuation multiples.

Discounted Cash Flow Analysis

This method uses the forecasted free cash flow of the target private company (meeting all the liabilities) discounted by the firm's weighted average cost of capital (the average cost of all the capital used in the business, including debt and equity), plus a risk factor measured by

beta. Since risks are not always easy to determine precisely, Beta uses historic data to measure the sensitivity of the private company's cash flow, for example, through business cycles.

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Key Components of a DCF

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Free Cash Flow (FCF)	Cash generated by the assets of the business (tangible and intangible) available for distribution to all providers of capital. FCF is often referred to as unlevered free cash flow, as it represents cash flow available to all providers of capital and is not affected by the capital structure of the business.
Terminal Value (TV)	Value at the end of the FCF projection period (horizon period).
Discount Rate.	The rate used to discount projected FCFs and terminal value to their present values.

Estimating Beta—Beta is a historical measure of a stock's volatility versus the market as a whole. Since private companies do not have equity traded on any exchange, there is no concrete method for determining the beta of a private company's equity. Therefore the estimation of beta is based on the trading volatility of comparable public companies. It is important to calculate the unlevered betas of the universe of comparable private companies.

βunlevered = βlevered / (1+Debt / Equity) (1-T)

Following the calculation of unlevered beta, determine the optimal debt ratio for the private company by either using the existing company capital structure or taking on the industry average capital structure. It is then that you must re-lever the average unlevered beta for the private company using the optimal capital structure.

βlevered = βunlevered / (1+Optimal Debt / Equity) (1-T)

Problems with Equity Risk Premium—Equity risk premium is the return that investors seek to obtain by investing in the stock market. Equity risk premium is the difference between the risk free rate and the demanded rate of return from the stock market. The equity risk premium for private companies needs to be adjusted to reflect a higher return for a riskier investment.

Estimating Cost of Equity—The cost of equity of a private company is calculated as a function of the risk free rate, beta, and the market premium.

Cost of Equity = RFR + Beta (MP)

The risk free rate is often known as the interest rate associated with what is considered a "riskless" security (typically the yield on the highest rated government bonds in the 10-20 year maturity range).

Estimating Cost of Debt—The problem with the cost of debt of private companies is that many private companies rely on bank loans as their primary source of funding. Bank loan rates are outdated and term structures are long-term. Therefore bank debt does not reflect the current debt cost of capital and is usually offered at a premium to public debt.

Calculating the current cost of debt capital would require analysis of comparable public company cost of debt or the approximation of the cost of acquiring new funding as of the valuation date.

After-Tax Cost of Debt = Cost of Debt * (1 — Tax Rate)

Estimating Cost of Capital—Percent of debt and equity is obtained from the capital structure.

WACC = (Percent Debt)*(Cost of Debt) + (Percent of Equity)*(Cost of Equity)

Special Problems with Private Company Cash Flows—It is important to normalize cash flows to reflect an arm's-length approach to management. Recasting cash flows for the private company is to determine the true value of the private company based on "real" cash flows.

Issues with Calculating Terminal Value—The two main ways of calculating the terminal value of a private company is through comparable multiples or perpetuity growth method. Considerations must be made in both methods that appropriate recast cash flows are used and growth rates are inline with potential growth opportunities for the private company based on management discussion and industry analysis.

Using the comparable multiples method requires that the private company's financial statements are recast to reflect the style of their public comparables. In addition, since private companies are organized under different corporate structure (LLC, LP or S-Corp), financial statements may not be a reasonable view of the private company's performance on which an earnings multiple may be used.

Final Observations on DCF Analysis

Valuing a private company using a discounted cash flow analysis requires consideration to be given to recasting financial statements to mirror public counterparts and adjusting components of the WACC to mirror current cost of capital in an illiquid market. It is important to make sure that all adjustments are reasonable and defensible.

The major disadvantage of this method is that the precision of the valuation is not always accurate. The outcome of the valuation is highly dependent on the quality of the assumptions made regarding FCF, TV, and the discount rate. As a result, DCF valuations are usually expressed as a range of values rather than a single value by using a range of values for key inputs.

Other Valuation Methods

- **Asset Appraisal**—Asset valuation applies to companies that have heavy fixed assets, such as manufacturing plants or refineries; it is appropriate to value the assets independently from the firm. An asset appraisal will yield a more accurate valuation than a discounted cash flow analysis in private companies such as these. In this method, the fair market value of fixed assets and equipment (FMV/FA) is calculated as a means of evaluating the business.
- **Break-up Analysis**—A break-up analysis is simply a sum of parts valuation based on different business lines. Each part is valued separately employing above

methodologies and then summed together. This is very relevant for private companies with dissimilar business lines.

- **Internal Rate of Return**—Internal Rate of Return is a valuation methodology that can be used to calculate the entry price, exit price, or average cash flows in an investment. IRR, given certain inputs such as exit price and cash flows within the investment, can be used to calculate a desired return rate, entry price, or other factors.

  Given the high risk on investment in venture capital and private equity, the firms require a high IRR in their target companies. In this case, the IRR represents the percentage of profits made on an investment in a specific period of time. Technically, the internal rate of return is the discount rate that generates a zero net present value.

  Ex. A firm acquires a private company for $35 million in 2011 and exits in 2012 at $70 million. The firms IRR is 100% with an NPV of $35 million.

  (Price Entered - Price Exited) / (1 + r)^t

- **LBO Analysis**—Another valuation methodology that is used is Leveraged Buyout or "LBO" analysis. Leverage is simply the use of debt; an LBO is the purchase of a private company through the use of borrowed funds, or debt. This method is used to determine the range of prices that a financial buyer would be willing to pay for a company based on target rates of return to equity (IRRs) and leveraged capital structure. Typically, the target company of an LBO analysis is public. The public equity is being bought out by a small number of investors, thus taking the public company private. In some cases, an LBO involves strong management support and participation. In such a case, management, with the help of a private equity firm, employ their own funds to take the public company private. This is also referred to as a Management Buyout.
- **Replacement Cost**—Similar to the total invested capital valuation; replacement cost valuation considers the total cost of reproducing the operations of the business in today's environment. This accounts for start-up expenses, real estate, equipment, and inventory and labour costs.
- **Total Invested Capital**—Cash generated by the assets of the business (tangible and intangible) available for distribution to all providers of capital. FCF is often referred to as unlevered free cash flow, as it represents cash flow available to all providers of capital and is not affected by the capital structure of the business.

Conclusion

How do you go about valuing a private company? It's a simple question with a complex answer. While there are numerous valuation methodologies that can be utilized to establish value, not all methodologies would be appropriate in all situations.

Among the techniques used for valuation of private companies; break-up analysis, asset valuation and DCF models are less feasible options as they require detailed financial information from inside the private company. Since private companies manage their balance sheet and earnings for different end goals than public companies, using discounted cash flow or comparable valuation techniques require additional insight. Due to lack of liquidity and increased risk in business, the discount rates used in DCF analysis needs to be modified accordingly. Therefore a more feasible approach is to find comparable public companies

whose values are known. Comparable companies' analysis is mostly used in M&A advisory, fairness opinions, restructuring, IPOs and follow-on offerings, and share repurchases. Furthermore, the trade comp approach is pertinent if there are publicly traded competitors; in its absence deal comp approach is used.

Each valuation approach has its own particular use and should be used in that respect. It is doubtful that any one analysis by itself will yield a pinpoint number that can be relied upon. Rather, it is likely that one will need to use multiple approaches to yield a range of values for a private company. Each methodology provides additional clarity on the other valuations. Evaluating the results of numerous methods provides a better understanding of a business' true worth. It is also important to note that different people will have different ideas on the value of a company depending on factors such as public status of the seller and buyer, nature of potential buyers (strategic vs. financial), nature of the deal, market conditions (bull or bear market, industry specific issues) and tax position of buyer and seller. A fair amount of experience, judgment and corporate finance and equity market knowledge is required. In each case, seemingly straightforward tools contain several hidden layers of complexity and restraints. PrivCo.com helps the private company valuation process by providing the comparable companies—both private and public—and comparable transactions needed in this process.

He asked what were the most common valuation approaches used for valuing a small software company in a slow-growing market segment with revenues around £3m, growing 20% per annum. The company has good technology though not killer

We can come up with any number of valuation methods, but the only one that ultimately holds true for a private company is the market-determined valuation. This is the price a buyer is willing to pay and that a seller will willingly accept for the business for sale.

Potential buyers may have completely different reasons for purchasing the business. It may be that the buyer is specifically interested in the targets technology, for which a grander application is planned. Or its established distribution channels. Or its outstanding human resources. The market-led valuation approach implies that the methodology for valuing a business should be determined by the purpose behind the proposed purchase.

Although ultimately the most accurate, this approach is not overly useful in enabling business sellers to quantify their expectations. So I'll take a quick look at some approaches used for justification of the setting of asking prices by vendors and offer prices by purchasers.

1] Asset Valuation
An accounting-based approach that subtracts business liabilities from business assets to arrive at the business value.

Simple at first glance you might think; but is difficult to know what assets and liabilities to include and to place a standardised value on them. If an asset is not included on the balance sheet – lets say a unique proprietary technology process, then it will not be accounted for in the valuation. Though you can be assured a business will always be worth at least the value of its assets less its liabilities.

More problematic is that this approach does not take into account the profitability of a business, so its application is limited for the valuing of most solvent trading companies.

2] Discounted Cash Flow

The Discounted Cash Flow (DCF) approach is a technical valuation technique used with companies, which are moderate to high cash generators or are soon *expected* to be cash-generative. It looks at today's value (at a given rate of return) of the accumulated profits of the business over a number of years added to the value of the business in today's terms if it were sold at the end of this period.

How might we apply this to the software company owner, if we knew his company generated cash and we decided to use this approach?

There are several ways to apply DCF. Here is an example where we shall project realistic cash returns for the next 5 years and discount them at a rate acceptable to an investor at 20%. So, let's say the projected earnings of this software company added up over the next 5 years came to £2m. At this discount rate, that £2m in 5 years is equivalent to £800k today.

We assess what the residual value of the company might be in 5 years time (apply an industry multiple to the average earnings in years 3,4 and 5 with a weighting to year 5). To make the calculation simple, let's say the residual value is £10m. Apply a discount of say 20% (well guess this is the acceptable investor rate of return) and you have a discounted residual value in today's terms of £4m. Add back in the discounted cash flow: £4m + £800k = £4.8m.

Some investment banks prefer to use the more scientific basis for calculating the discount rate: the weighted average of the costs of debt and equity capital. Here's an example. The business has post-tax cost of debt of 7% and an estimated cost of equity of 25%. It plans to raise capital 30% by way of debt and 70% by way of equity and computes the cost of capital at 19.6% as follows:

	Capital Split	Cost	Weighted
Debt	30%	7%	2.1%
Equity	70%	25%	17.5%
Cost of Capital			19.6%

So what are the problems with the DCF approach?
It is not easy to apply! To forecast the future cash flow of the business, you are going to have to prepare a full financial model. This is going to need some serious analysis of the business, the macro-economic environment, the legal and regulatory framework and the competitive landscape.

To complete the equation, we still have to make a judgement on the residual or terminal value of the business, for which there are several calculation methodologies. The terminal value is sometimes determined using multiples from comparable firms.

Or we can assess a terminal value by sticking to the DCF fundamentals. This is often called the perpetuity method and assumes a growth rate g of a perpetual series of cash flows at the end of the period (5 years in the software company example).

Tp = (CFp x (1+g))/r-g

Where:
Tp = the terminal value at the end of the period p

CFp = the projected cash flow in period p
r = the discount rate
g = the estimated future growth rate of the future cash flows beyond p

The other problem the valuer is faced with is that if the current or expected market conditions are turbulent, forecasting cash flows maybe pure guesswork.

Other complexities also come into play. To an extent the acquired company's future cash flows depends on the acquisition method and the purchase price. How is that? The acquired business's future cash flows are directly affected by the taxes it will pay. The taxes the company will pay depend on its taxable income. And the taxable income will partly depend on its taxable deductions for depreciation and the amortization of intangible assets. These deductions depend on the acquired company's tax basis for its assets, which in turn depend directly on the purchase price paid for the company.

3] Comparables Valuation
Here an attempt is made to extrapolate or interpolate the value of the business by using information collected on similar business sales in similar markets. This approach is the closest simulation of a true market-led valuation.

The market has paid x for ABC; the market has also paid y for DEF, therefore because of the similarities between ABC, DEF and YOURCO, we can estimate that there is a strong probability that YOURCO will fetch z.

Certain industries have their own rules of thumb that are commonly used as comparison standards for setting prices for businesses for sale. Usually these are profit multipliers for an industry sector within a country, but sometimes the rule is based on another variable peculiar to the industry i.e. barrelage in the pub sector, customer numbers for a mobile phone air-time provider. But just because a rule of thumb has been extensively used in the past does not mean that it is necessarily the right approach to take particularly when the rule of thumb is based on a criteria other than net profitability.

The profit multiplier or price earnings ratio is a common business valuation guide used, especially in the UK, when a business is both established and profitable. It saves us from having to deal with the forecasting issue when cash flows are difficult to predict. But always use this cheap and cheerful method with caution; the value you end up with may be substantially different to the figure produced by a business valuation expert with experience in your industry.

To see how this variance may occur, let's look at two hypothetical companies that operate in capital-intensive tech sector. Let's assume this sector uses a rule of thumb that estimates the value of a company as 6 times EBITDA. We will assume that these two businesses are identical in every way with the exception that one business has plant and equipment that is newer and more efficient, requiring much less re-investment in capital assets to sustain the business.

Company A and Company B both have EBITDA of £1m. Ostensibly, according to the industry rule of thumb, they are both worth the same at £6m. But Company A requires £200k of capital investment each year to sustain the business, whereas Company B needs only £50k. Would you not prefer to purchase the business with the higher cash flows? On close

inspection it transpired that company B had substantially higher admin costs that could be trimmed right back upon acquisition giving the purchaser a much higher ROI.

Comparables valuation is a clearly useful approach when the right information is available on other companies that we know are similar in most respects. Unfortunately, this information is not always able to be collected. It is more often used in industries with simple business models and where there are many players. With larger and more complex business, there are fewer comparable companies.

However, in the absence of comparables, the profit multiplier technique is still widely used as a valuation yardstick. I often see private companies go up for sale for between 2.5 to 5x earnings (generally the higher the annual revenue, the higher the multiple). Why is it 2 1/2 to 5 times earnings? Well, to buyers, such a multiple represents getting their investment back in 2 and a half to 5 years from profits. That's equivalent to a projected annual return on investment between 20% and 40%. And this is the type of return rate that encourages buyers to take the leap of faith to buy an existing business.

Buyers will often use one or more of these approaches to see whether the result of the calculation falls close enough to the asking price to give it some validation.

These are the most prevalent valuation approaches used in the market. If you are looking for more, you need only go to half a dozen business brokers or valuers and ask them to assess the value of the company and to explain to you how they get to the figure.