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How To Value A Company

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Which is more correct?

A. *Definition of valuation in business school:* net present value of discounted future cash flows.

B. *Definition of value in the real world:* value at which a buyer and a seller reach agreement and funds change hands.

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Answer: Both are correct but select "B" if you have to choose one.

When we have management teams approach us to represent their companies in seeking new equity capital and the subject of valuation comes up, the CEO or CFO will say something like: "Well, since you're our investment banker, you'll do a valuation and that's how we will price the equity, right?" "No, not exactly," we respond.

If that's not right, how IS valuation determined? It's OK to start with "A" above but "B" will ultimately determine how the deal is done.

Let's look at this subject of valuations in an orderly manner. We should agree on a fundamental principle first: There are lots of reasons why a company might have "value" in the eye of an investor (e.g. market share, proprietary technology, competitive advantage, etc.) but the only thing that *really* matters is cash flow, cash flow, cash flow.

Having agreed on that, here are some *theoretical* valuation formulas.

(1) Valuation of Historical Cash Flows. This is most common in established companies with solid, predictable trailing operations. Usually this method is accomplished by multiplying past cash flows by a "multiple" which is, in turn, derived from a review of "comparable" transactions.

Determining a truly applicable multiple is a tricky subject. One method would be to look at other similar companies and at the valuations placed on them by arm's length transactions. This is hard to do in a private marketplace where not all transactions are disclosed.

Another method is to look at similar companies that are public and see what multiples the public markets place on those companies' stocks. To do this, one must determine a discount to apply to the public value to account for the illiquidity of the private company. This is also very hard to agree upon. Reasonable people may, and will, differ.

(2) Appraisal of Fair Market Value. This method requires the valuator to look to the general market and to seek to determine the value of the enterprise in relative terms to the market. This might be done as a calculation of price to gross revenues, price to earnings, as adjusted for various items, price to assets, etc.

Appraisers sometimes use a weighted combination of several of these methods, relying on their professional experience and judgment to determine proper weighting. Or, in the case of troubled enterprises, the value may lie primarily in an assessment of the value of the assets themselves. Even this, though, has its complications because one must determine if that value is to be estimated based on orderly or forced liquidation.

(3) Discounted Future Earnings. This formula is the trickiest of all because it requires a determination of risk of performance. That factor becomes increasingly more difficult to estimate as past performance is less reliable or even nonexistent.

These are the valuation formulas most often employed. The Golden Rule, however, comes into play along about this point: "Them that has the gold makes the rules."

Once you move past the theoretical, you arrive at the practical and you must understand how the investor, especially a professional investor, is looking at the subject of valuation.

Assuming he likes the company and wants to do a deal, he then assigns his capital with a hurdle rate of return required. Let's say that required rate of return is 35 percent for each year the funds are invested. He will use his version of the company's projected cash flow, seek to estimate what a likely exit value will be in five or seven years, and then calculate how much of the company he will have to own at that time to meet his assigned hurdle rate.

Where the company raising money gains leverage in the process is to create a competitive atmosphere (an "auction" if you will) so that investors who really like the company realize they must up the ante if they want to win the deal. It's amazing how theoretical valuations can increase under the pressure of competitive bidding.

We've seen an amazingly wide range of valuations from competing investors. One transaction, for example, resulted in six terms sheets offering equity to management ranging from 15 percent on the low end to more than 50 percent on the high end. That was more than $30 million of difference in wealth-building opportunity to management.

And that's how you value a company in the real world.

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