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The Corporate Advisor

INNOVATIVE EQUITY

What is Your Business Worth?

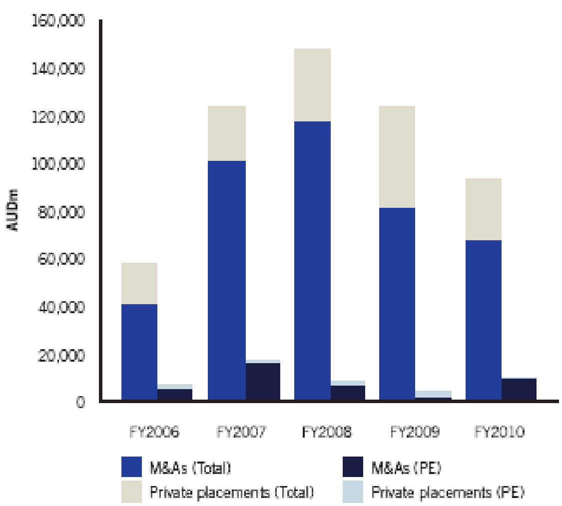
One of the most crucial issues in a venture capital or private equity transaction is the value of a business. Understandably, entrepreneurs have a natural bias to overvalue their businesses whilst potential investors tend to be more conservative. We look at various types of businesses and attempt to identify what its true value might be to a potential buyer/investor.

The most common basis for valuing SMEs is this year's profit times a multiplier formula. The profit figure may be an after tax figure or it could be earnings before deducting interest, taxes, depreciation and amortisation or commonly known as EBITDA. Thus if your business was generating $500,000 this year and your multiplier was 1, then your business is worth $500,000

So what determines the multiplier factor? Because it is obvious that if you had a higher multiplier, than you could sell shares in your business at a higher valuation.. **The key factor in being able to command higher multipliers is having assets to sell.**

What do we mean by assets? Let's take the case of my business mentor's very first business venture which was an insurance broking business. The business was generating $3m a year but he had no assets to sell except a client base. All the value in the business — which are the insurance products — belonged to the insurance company.. Thus when the time, came to sell the business, he was offered $300,000 only! A multiplier of 0.1!

Value of M&As and private placements (Australia)



The insurance broker's client base was not an asset but a revenue stream. It is easier to scale up the value of an asset than a revenue stream as we shall see below.

For most emerging sole traders that have their own proprietary product to sell, this type of business can command a one times multiple. The product needs to be his or her own creation or it could be an innovative business process for solving complex problems. It is an asset that can be on sold.

And as the business achieves a some measure of success, it finds that it may have the resources to hire some staff and implement more systems. By this stage the business is able to command a three times multiple valuation. That is if the business was generating $1m a year, it would be worth 3X times that or $3m. It should be noted that this is the most common multiple used to value most small businesses in Australia.

Having survived for some long as a single product business, the company develops new products to sell to it's existing customer bases. The aim here is to provide a fantastic customer experience with one product which will entice clients to try the company's other products. A classic example of this strategy is Apple's Itunes creating demand for Ipod which eventually entices customers to invest in an Apple computer. Such businesses are able to command a valuation multiple of 6X earnings.

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As you create more products to sell, you will be driven by the need to identify different distribution channels. For instance, Grange winery identified the gift market as a possible new outlook for its higher end wines. Such multiproduct multichannel business can command10X valuation multiple.

For those businesses which have become large enough to create a brand presence with multiple products and multiple channels, you could command a valuation multiple of 15 times.

And if your business model is one which is easily scalable, than you have the potential for high speed growth which could justify a valuation multiple of 20 times. MacDonalds is a classic example of a scalable businesses. All the systems and processes are standardised to the last detail This enables business model to be reproduced very quickly in many different locations. The look of a MacDonalds restaurant is the same wherever you go. Even a junior customer service staff can refer to a company manual to learn how to make French fries,

Many internet businesses are also highly scalable requiring minimal effort to scale up in size once the initial business model is proven. That is what's make them very popular with venture capital.

So how much do you think you business is worth now? The answer really comes down to what a seller is willing to pay for your business, which in turn is dependent on what the business would be worth to them. The most standout example of this logic was the Facebook acquisition of Instagram for $5bn. This is despite Instagram having no revenues at all. But Instagram's huge client database provided Facebook with a valuable distribution channel for its products. This is the ultimate example of where having an asset to sell is worth more than having a revenue stream.

If you have a valuable product to sell but find it tough to establish a foot hold in the market place, that product could be an extremely lucrative asset to a large corporation who has the means and clientele to scale up distribution quickly. In this case, the business would be worth more than just the profit X multiple formula. It would be worth what the investor would be able to financially gain from having access to your product. Remember, the buyer would also benefit from not having to spend years in trying to reproduce your product.

It also helps to justify your valuation if you could identify comparable venture capital or private equity transactions which have occurred recently in your industry sector. But don't use a stock market valuation multiple as a basis for SME transactions. SME's typically sell at large discount to listed companies values because they are illiquid. The discount is not fixed and varies according to investor sentiment, Investor sentiment being driven by the state of the economy, or sector outlook or the state of the stock market— as bullish sentiment in the latter can often boil over into private market transactions.

A seller's focus on valuation is understandable. But quite often entrepreneurs do not realise that being demanding means either losing investors interest or being forced to include extremely dilutive clauses in the sale contract should your company fail to perform in two to three years time. Your moment of glory on having outdone the investor may be short-lived. More often than not, only the funds and investment banker will be feeling victorious in two to three years time.