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# WHAT IT'S WORTH

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Quick Summary: The valuation of a company discussed in an M/A transaction can vary widely.

Abstract:

Although sophisticated models and rules-of-thumb can be used to calculate the valuation or value of companies involved in a merger or acquisition, the reality is that the collective opinions of others determine company values. For publicly traded companies, the common method is to rely on market capitalization to determine a company's value. For privately held companies, determining its value is nowhere near as clear. In fact, very wide discrepancies are common, which can short-circuit a transaction quickly and permanently.

This is the second to the last of the fifteen articles in this chapter. However, it discusses the first thing on everyone's mind when there is a hint of a merger or acquisition of a company: The core question is what is the company worth or its value? But what <u>is</u> value? Books, college courses and seminars, thousands of consultants, and virtually everyone associated with Wall Street and the entire investment community have methods of calculating a company's value. Some definitive mathematical models can be used to calculate a company's value based on strict definitions of value. Unfortunately, there is little agreement! The real answer, which most financial professionals and business owners don't want to hear, is that a company's value is just someone's opinion!

For publicly traded companies, the "opinion" consists of the consensus of those who own stock in the company -- IF a company's value is defined as its market capitalization. That number is easy to calculate: It is the number of outstanding shares times the per-share price. As we see daily, stock prices can vary widely. One bit of news, whether it is verified or not, can send a stock plummeting or rising. In reality, a company's inherent true value does not change daily or at the whims of Wall Street or some blogger. In theory, the company's stock price should reflect the investors' opinions of the company's future earnings, which, of course, no one knows, but they can only guess. A Weegee or dart board, an Excel™ spreadsheet, or a supercomputer model will probably provide equally reliable results. Many will view the above comments as caustic or cynical, but the fact that a company's value relies heavily on opinions is indisputable.

For private companies, the major focus of this chapter's articles is that the situation becomes far more nebulas. For them, the "collective opinion" may consist of <u>one</u> person's opinion – the potential buyer or seller -- instead of millions of owners of the shares of public companies. Financial "experts" may be brought in to help create and rationalize the number. They may use one or several different modeling techniques to arrive at a "fair and equitable" number. The more common techniques include:

**Comparable Comparisons**: With this method, a company is compared to other similar companies (same size, business, maturity, etc.) for which data is available. Unfortunately, for early-stage companies, there are rarely true comparable companies and data is very scarce.

**Post-Money Valuations**: If a company has recently raised a funding round, an argument could be made that the company is worth the post-money valuation paid by the most current investors plus or minus some "factors."

**Revenue Multiple**: This method is very simple. A company's current (or last year's) sales are multiplied by some factor to determine its value. The factor is selected based on some industry norm for other "similar" companies or for the specific market sector in which the company participates. For companies that are experiencing a fast revenue ramp, basing value on past performance may underestimate the company's value. However, for the purchaser, they may have doubts that the company can sustain its past revenue ramp.

**Earnings Multiple:** This is the same method as described above, except earnings, not revenue, are used with an appropriate multiplier. This method, although quite logical, is problematic for many smaller companies. These companies are probably not operating with the proper scale and, in fact, may be operating at a loss. They may be interested in a merger to leverage the capabilities of a larger company to reach a profitable scale.

**Discounted Cash Flow**: This method is almost "magic" in that it estimates the current value of all future cash contributions from the profitable operations of a business. This method involves many assumptions that can have significant impacts on the final number. It is elegant but fraught with risk.

**Replacement or Duplicate Costs**: With this technique, a buyer estimates how much cash (and time) it would take to duplicate the current business of the other company. This is the classic case of a company trying to decide if they should buy a company or turn to their internal resources and "do it ourselves." This method often does not take into account the patents, trade secrets, "know-how", team expertise, customer relationships, and market knowledge that the original company has accumulated over the years. The opportunity costs of spending the resources to duplicate the offering and the later market entry also need to be considered.

**Intangible Assets**: Although intangible assets such as patents, trademarks, brands, customer relationships, and even the reputations of the key employees are not direct factors in valuing a company, they can be used to add justification to one of the methods described above. Once again, the value of these intangible assets is based on opinions. A good example is the value assigned to a patent. The patent owner may place a premium on the patent as a tool to keep other companies from offering the same or similar product. On the other hand, a purchaser may view a patent as only a "nice to have" asset realizing that a patent is only a competitive deterrent if an infringement case is won after extensive litigation that can take years and cost hundreds of thousands of dollars. Infringement litigation cases are only successful about half the time.

Many other techniques can be used. It is not uncommon for a financial analyst to use multiple different techniques and then apply weighting factors to them to arrive at a numerical "consensus" number. Even with this seemingly objective approach, opinions direct the overall outcome.

Probably the best method to determine a private company's valuation is to listen to the sage advice of Rick Burnes, the co-founder of Charles River Ventures, a highly successful venture capital firm. Rick said, "Companies are bought not sold" and, "A Company is worth one dollar more than the second-place person is willing to pay." So, a company's value is determined by what the purchasers are willing to pay; not a penny more or less!

Often, there is a huge disconnect between a seller of a small, tightly held company and a buyer from a larger, more mature company. This is especially true when the seller is an entrepreneur who has spent years struggling to build their business. They naturally want to be compensated for the years of bootstrapping, make little or no money, and make personal and family sacrifices to finally build their business. The buyer, on the other hand, is not looking backward but is looking forward to the future revenue potential of the company. The buyer may appreciate what the entrepreneur did but is not willing to compensate them for it at the level that the entrepreneur expects. It is common for the parties in this situation to be an order of magnitude apart from their initial positions. Once such a wide discrepancy is exposed, it will be hard for both companies to ever come together. Resorting to "logical" financial models will do little to change the deep-rooted beliefs and the corresponding impressions that were made after the first shocking discrepancy was discovered.

Valuation discussions are never easy. Perhaps they should occur at the very beginning – not to form the basis of the negotiated price, but to determine if the parties are even in the ballpark. Once it is determined that a fair and reasonable deal, as viewed by both parties could occur, following the structure and flow of the articles in this chapter probably makes sense. If not, quickly move on to avoid the unnecessary turmoil these discussions will have on all individuals involved.