BENCHMARK
INTERNATIONAL

VALUING COMPANIES

7 POINTERS FROM 30 YEARS' EXPERIENCE IN THE UK

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INTRODUCTION

As someone who's been involved in mergers and acquisitions in the UK for over 30 years, and involved in at least 500 deals, I've had a lot of ***'penny dropping'*** conversations with buyer and seller clients alike. This article gives an introduction as to how companies are valued in the lower to mid-market in the UK, focusing on the most common issues and misconceptions.

Without any doubt, the best way to get your company in the right shape for exit is to understand how buyers will value your company when it actually comes to selling and to plan accordingly. Another important factor is understanding who might buy your company in the future and, if possible, tactically building their awareness of your company between now and then.

We do see some differences in language and approach to our US business, but these are not generally significant. In fact, one of the great things about discussing different approaches with colleagues worldwide is that we all learn.

One aspect not covered in this article is the tax position of sellers as this will vary from one individual to another and from one jurisdiction to another. We do say that we mustn't let the 'tax tail wag the dog', but this is often impossible to avoid. Professional tax advice is always a must.

NICK HULME
MANAGING DIRECTOR

1

IT'S NOT JUST ABOUT THE NUMBERS

There's one fundamental difference between how sellers and buyers view transactions.

For sellers, this is often a life-changing decision – the sale of the family silver, perhaps – but for corporate buyers this is fundamentally an ***investment decision***. Although, of course, the most successful buyers will be the ones that grasp the many emotional aspects of the deal and work tirelessly to maintain great relationships throughout the process and beyond.

As an investment decision there are two fundamental parameters:

- **i.** ***Cost*** - being the sum the buyer will pay for the target company; and
- **ii.** ***Return*** - being the profits (or earnings) of the target company after the deal.

These earnings will primarily be those made by the company being acquired but can also include the additional earnings a deal will bring to both seller and buyer. Therein lies a much deeper discussion, and negotiation, around who benefits from the synergistic gains.

You will hear a lot of talk about earnings and multiples, but the M&A sectors' obsession with formulas can cloud what matters most. Before we discuss the raw mechanics of company valuations, I will draw your attention to the factors that are often forgotten:

1. ***A company is worth what a buyer is prepared to pay for it*** – fundamentally it's all about supply and demand. There is no substitute for ***'testing the market'*** to gauge real buyer appetite and valuation.
2. ***Although the numbers are important, we must keep in mind the essence of the opportunity that is on offer*** – "What is it about this company in this market that will drive its value?" It might not be the company's profits this year or next, it might simply be the glaring ***opportunity*** ahead of the company, or the fact it is capable of producing higher returns year-on-year than have ever been shown in the past.
3. ***The basic valuation principles do not apply to all companies*** – ponder the valuation of a software company that has not yet turned a profit, or a quarry that has 100 years of stone still in it. Or companies in a number of sectors where ***rules of thumb*** have developed over many years as approximations to these basic principles (financial adviser and accountancy practices, or hotels and care homes, for example).
4. ***Beware the accountants in the room*** – as a Chartered Accountant (the UK equivalent of a CPA) who has operated at the highest level in the profession, I know first-hand the pitfalls of asking technical accountants to value a company. My own experience of clients' accountants is that they value their clients' companies too highly. Not necessarily because they don't want to lose the company's business, but because they care so passionately about their clients that they are simply ***too protective***. They can also get caught up in an overly complex number-crunching exercise. On the buy-side too, accountants can under-value a target company for the very same reason. Neither is conducive to achieving the end goal.

"The fundamental essence of the opportunity can be more important than the financials, but we must understand the numbers too."

This is the basic formula:

Enterprise Value (the value of the business itself) = Multiple x Earnings

Put another way – the number of years' earnings a buyer is expected to pay for a company.

2

'MULTIPLES' ARE A MINEFIELD

Let's start by making a comparison between company valuations and commercial property investments (or real estate in the US), where investors talk in terms of required annual yields.

Consider this example:

- If the rental income from a commercial property is £100,000 per annum and the required yield for that property is 10% per annum (taking account of factors such as location, condition and tenant), the market would value the property at £1 million. An investment of £1 million gets a return of £100,000 per annum = 10%!
- If instead this commercial property was a company, all things being equal (which of course they are not), earnings would be £100,000 per annum and the valuation of £1 million would imply a multiple of '10 times'. 10 x £100,000 = £1 million.
- In this example, an investor with £1 million to invest would have a choice – to invest £1 million for a relatively secure return of £100,000 per annum from the commercial property, or to invest £1 million in a company that could provide returns of more than £100,000 per annum with the right strategy (or less with the wrong one!). The purchase of the company may well be perceived as being riskier but, as we all know, risk works both ways!

In comparing a company purchase to a commercial property investment, a mathematician will tell you the multiple is 'one over the yield'.

The market for small to medium sized companies, after many years of activity, has settled on a broad range of multiples that most advisers would recognise. How then, as a seller, can you fathom what might be the ***most appropriate multiple for your company***, and who do you believe if different advisers tell you different things?

Let's consider some of your options:

- You could perform ***desktop research*** based on similar deals in the same sector, although this would immediately be flawed as the price paid for companies and their reported earnings would be distorted. The accounts will be out of date, they will not provide sufficient information to understand the underlying earnings of the company, and they will give no indication as to the company's future prospects. The deal value that's available in the public domain will also be blurred, principally as sellers can shout loudly about the amazing price they achieved for the company, whereas buyers prefer to show the market what an amazing deal they did. Neither will take account of the impact of the 'structure' in the deal; or
- You could go one stage further and attempt to compare your company against a number of apparently similar quoted companies. A glance at the Financial Times will show you the ***current price to earnings ratio*** (P/E ratio) for all listed companies. This is the price per share for any particular company on a particular day compared to the 'earnings per share' from the most recently published accounts. This approach is also flawed as you would soon glean from the hugely varying P/E ratios for a list of companies in any sector. There is also often a gulf between the size and marketability of these quoted and unquoted small to medium companies; or
- You could engage one or more professionals who are used to buying and selling companies of a similar size to yours and obtain a range of views.

At Benchmark International we use a ***tried and tested range of multiples*** that will apply in most situations, from a lower multiple for 100% 'cash on completion' deals to higher multiples where there is likely to be a lot of interest with strong competitive tension, or a degree of 'structure' (I've mentioned this twice now – more to follow). We provide our clients with on-going revisions to our ***Valuation Matrix*** as marketing progresses and as earning assessments evolve or are tailored to particular buyers. Our experienced executives will discuss their reasoning with clients for focusing on target multiples, and negotiate deals accordingly.

So, which multiples?

Initial offers for low to mid-market companies in the UK normally reflect multiples of ***four to six times***. When fully negotiated, deal multiples normally settle between ***five and seven times***, depending on structure. On some deals, a multiple of four or five times which is paid mostly in cash can be attractive, whereas on other deals a higher multiple can give a deal the structure required to meet the objectives of both parties. With high growth prospects and/or carefully managed competitive tension, or with true mid-market deals, ***multiples can be much higher.***

The very best multiples will be achieved for companies with all the right attributes. If you can place a tick against a couple or so of these, you are on the right track:

- ***A strong management team*** – capable of running the company without the sellers' involvement going forward.
- ***Great products or services in a big market*** – buyers need to know they can ***grow*** the company quickly.
- ***Technology enablement or market disruption*** – a current hot topic is the ability of 'tech-enabled' companies to create competitive advantage in existing and new markets.
- ***High margins*** – meaning a buyer, or investor, can increase earnings quickly by growing the top line.
- ***Good customer and supplier spread*** – high concentrations of either creates risk.
- ***Post-completion synergies*** – where either company, buyer or seller, will benefit from income or cost synergies post-deal.

The prospect of exponential growth is the biggest driver of what I refer to as ***'silly' multiples***, 'silly' being a good word if you are selling!

Consider the extreme example of a company with earnings of £1 million now, that are set to grow to circa £5 million in a couple of years. A buyer might just be prepared to pay £25 million for this (a multiple of five times), with some 'structure' perhaps. This might imply a multiple of 25 times for the seller (comparing the £25 million value with earnings of £1 million), although if the buyer has the £5m earnings in mind, this could look more like five times when presented to 'the board'. The plot thickens as the seller's last filed accounts might only show half the current earnings, ie £0.5 million, so a researcher looking at this deal could see a multiple of 50 times! It's a 'silly' example but makes a serious point.

A minefield indeed!

3

THERE'S MORE TO EARNINGS THAN REPORTED PROFITS

Having established a suitable range of multiples, let's turn to the issue of earnings, which is best described in terms of ***the earnings a buyer would inherit with ownership of the company***. We are essentially looking for earnings 'now', normally derived from annual or management accounts and adjusted to take account of current trading. In some situations, it might be appropriate to look at a combination of the last six months' earnings and the next, and in others it may be more appropriate to focus on 'run-rate' or other similar indicators.

A word of caution. If your company's earnings are expected to grow rapidly after a sale, this growth will be reflected in the multiple. ***Applying a high multiple to future higher earnings would be to double-count*** which is not something buyers accept. Benchmark International's valuation matrix does often include higher earnings assessments, however, to reflect how the valuation might change if these earnings are visible at the time of negotiating a deal.

The most common adjustment is to restate the cost to the company of its shareholders, taking account of their true role and responsibilities and often adjusting to market rate remuneration. Where owners take low salaries, this would require an upward adjustment, but where owners take salaries or pension contributions well above market rates, this would require a downward adjustment. In the buyer's mind, they will be thinking in terms of

the cost they will need to budget to employ someone to do the business role that you did, which can be quite different to the full cost to the company of its owner!

Other adjustments would typically be to exclude, or 'add-back', one-off costs. What you cannot do, of course, is adjust for 'everything including the kitchen sink' just because you want to. Buyers are smart. But that's not to say we can't negotiate.

The term we use in the UK for a fair assessment of sustainable or normalised adjusted earnings is 'Maintainable Earnings'. Other commonly used terms tend to reflect a more historical approach, such as 'Adjusted EBITDA' (earnings before interest, tax, depreciation and amortisation) or 'Historical EBITDA'. I much prefer 'Maintainable Earnings' as this is a better reflection of the numbers and the story behind them and, of course, is not laden with reference to the past.

"Maintainable Earnings reflects the true underlying profitability of the company at the point of sale."

A word of caution when we consider adding back depreciation in order to inflate the earnings assessment. Although depreciation is an accounting adjustment – a non-cash item – buyers will often resist this. Any accounting definition of depreciation will include reference to 'writing off the cost of an asset over its useful life'. The clue is in the word 'cost'. If there is a significant cash cost to a company of replacing its assets annually, a buyer will factor this annual cost into its assessment of maintainable earnings if adding-back depreciation. A company that has already heavily invested in long-term assets might well be able to add-back depreciation but, for a company with a rolling annual capital expenditure requirement, this will be more challenging.

4

YOU CAN'T ADD THE VALUE OF COMPANY ASSETS TO THE VALUATION

"What about my assets, they must be worth something too?". If I had a penny (or a dime) for how often I have been asked this question …

If these assets are ***truly 'surplus'*** to the company's operations, then perhaps you can add them to the valuation, but if they are ***fundamental to the company's ability to generate its earnings***, adding them to the valuation would simply be double-counting (which we know buyers don't accept).

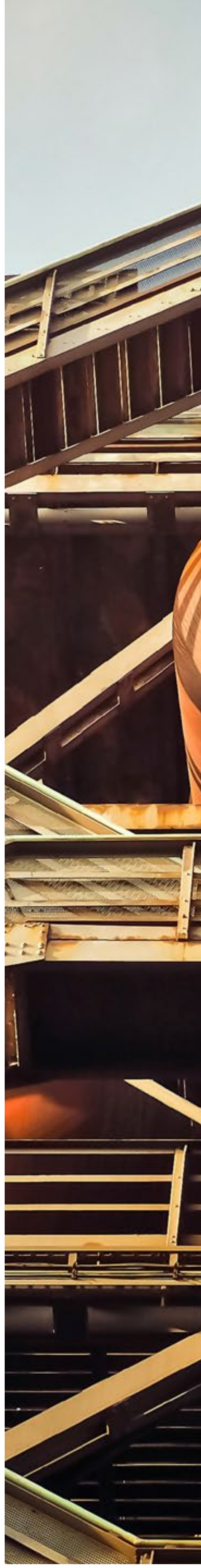
The most common 'surplus asset' is what we refer to in the UK as 'free cash'. This is essentially the cash on the balance sheet that could be extracted by the owners without affecting the company's operation but hasn't been for one reason or another. Think in terms of the cash that has been retained for a project that is no longer required, the cash from the sale of quoted investments, or even the cash from the sale of the Bentley or yacht.

Adding 'free cash' to the valuation on any deal is rightly riddled with checks and balances, and in the UK significant tax complications. Advisers can lock horn for weeks before agreeing the sums or mechanisms for sellers to extract this cash as part of a deal. The agreed 'number' needs to be fair to both parties and no buyer will allow a seller to artificially inflate completion cash balances to fill their own pockets. The mechanism used normally takes account of the relationship between cash and working capital (as they normally move in opposite directions) with the agreement of a target working capital figure at the date of deal completion. This is definitely one for another day.

The opposite of cash, though, is debt, which is why ***most deals are referred to as being on a 'cash-free, debt-free basis'.***

Many sellers initially struggle with the concept that a valuation of the company will be reduced if there is debt on the balance sheet. The overriding principle here is that a buyer will expect to inherit a 'clean company' and therefore any non-trade debt (eg bank loans or finance leases) needs to be effectively excluded from the balance sheet at completion. In fact, as Maintainable Earnings itself is on a pre-interest basis, like Adjusted EBITDA, it follows that 'no interest' must also mean 'no debt'.

I often explain this another way. If your company has a lot of debt on the balance sheet, you will instinctively know that actual cash generation is much less than the profit stated in the accounts due to both interest and capital repayments. Adjusting for debt in valuations effectively ensures the valuation is aligned with actual cash flow, as opposed to accounting profits, which is what a buyer is really interested in. I often ask my seller clients a straight-forward question: "If your company is as profitable as the accounts seem to suggest, then where is the cash?". The response normally reveals an appreciation that the true value of the company must factor in the amount of debt on the balance sheet at the point of completion.



"It's a lot easier for sellers to understand why 'free cash' can be added to the valuation than it is for them to understand why 'debt' needs to be deducted."

Two asset types worthy of separate mention are commercial properties (real estate) and goodwill.

Purely for valuation purposes, a company's trading property is often notionally treated as a surplus asset, for two reasons. First, the fundamental principles of valuation of companies and properties differ (as mentioned above) and, in fact, treating the property as a separate asset can enhance overall valuation in many cases. Second, most buyers of companies want to do just that – buy companies – whilst property investors are quite different. In separating out the valuation of the property as a surplus asset, the company and its trading property can be marketed separately in a sale process. In this case, earnings are adjusted to reflect what is referred to as 'notional rent', which might become the actual rent if a buyer of the company decides to rent the property from the seller instead of buying it.

Another interesting asset is 'goodwill', the 'value' of which that cannot be added to the company's valuation simply because the company's earnings are underpinned by its goodwill in the first place. In accounting terms, goodwill is the difference between the price paid for a company and the book value of the assets at the date of completion, so it's a little more than a number that accountants use to balance the debits and credits!

REVISING THE FORMULA:

Value = Enterprise Value (ie Multiple x Maintainable Earnings] + Surplus Assets – Debt

5

COMPLEX DEAL STRUCTURES CAN CLOUD VALUATIONS

Everyone knows the maxim ‘a bird in the hand is worth two in the bush’, and this is one of the reasons Benchmark International presents valuations based on a range of multiples. Other reasons include the impact of enhancing factors such as growth and competition amongst buyers.

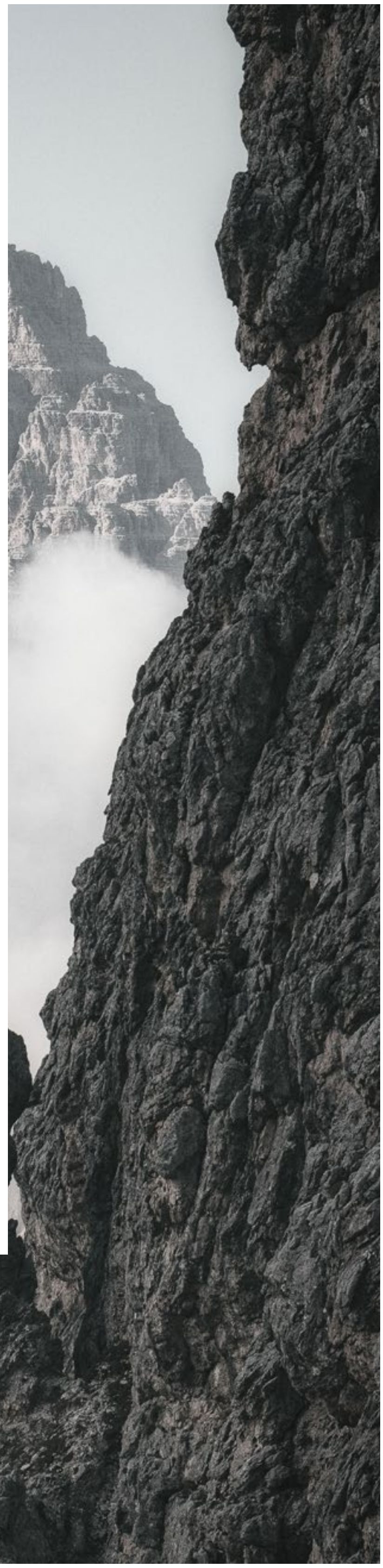
“A buyer can make what looks to be a great offer but understanding how the deal is structured - when and how the money is paid – is essential.”

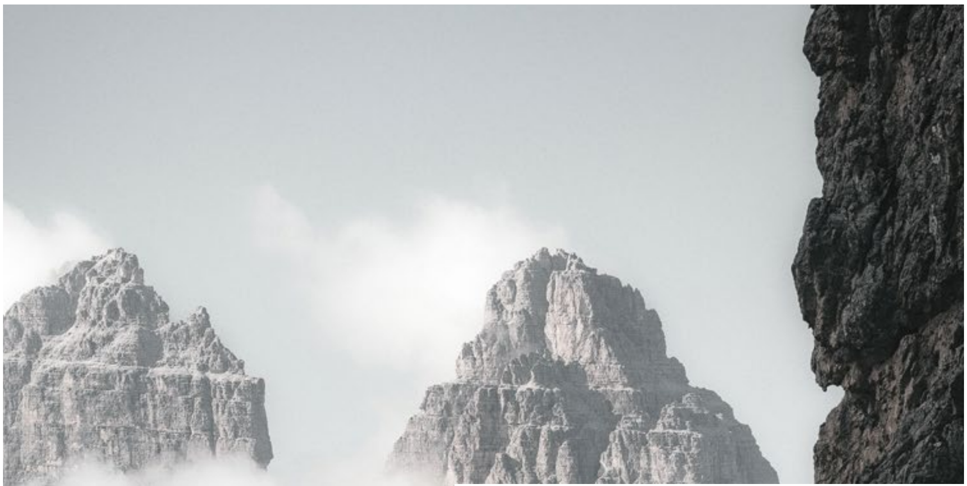
The most common types of ‘structure’ are vendor loan (or defcon, where some of the consideration is paid over time), earn-out (where future payments are made depending on performance) and retained shareholdings (where the seller might keep a stake in the company or in its new owner).

‘Structure’ is generally used to bridge two stumbling blocks:

i. ***Differences in valuation between buyer and seller.*** The buyer is essentially saying to the seller: “We will pay you the higher figure if you do what you say you will”; and
ii. ***A buyer’s ability to fund a deal.*** A buyer might not have sufficient funds to complete an acquisition and might look for a vendor loan or might be highly focused on the investment equation we discussed earlier (ie the less cash they use to make the acquisition, the higher the rate of return from it).

It’s rare to see offers for companies that don’t include at least some element of structure, so issues such as buyer credit status, interest and security come into play.



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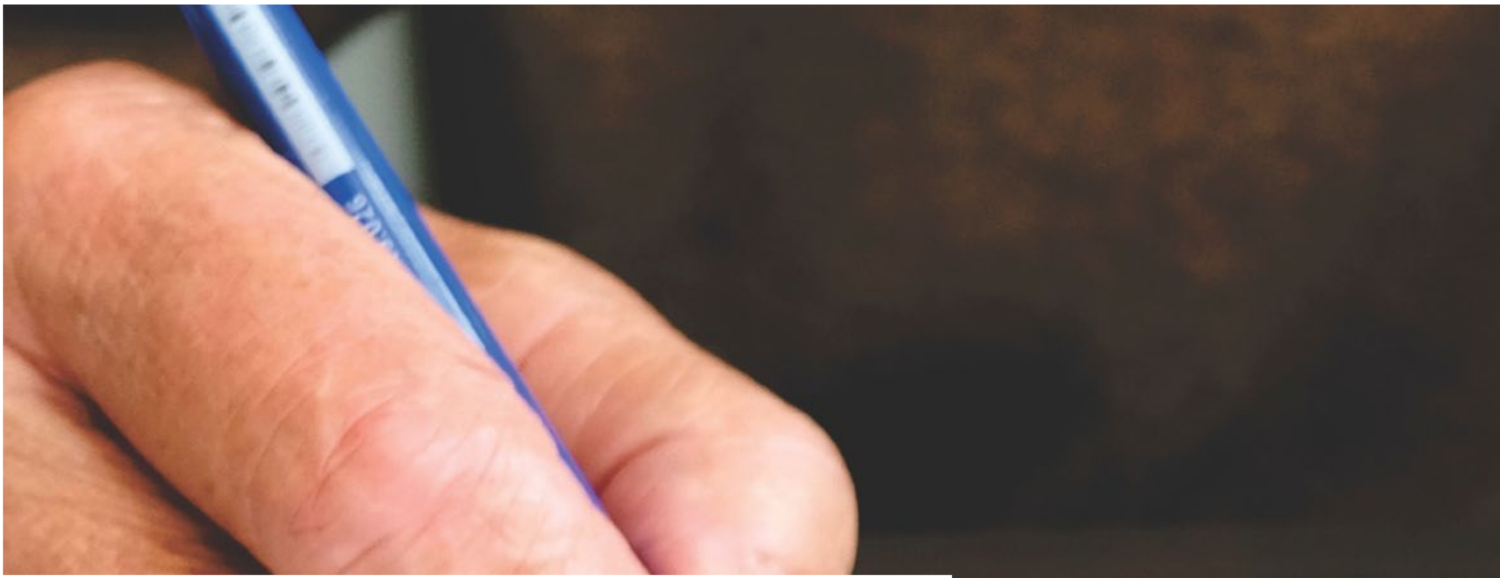
BEWARE VALUATIONS BASED ON NET ASSET VALUE (NAV)

On rare occasions, particularly where companies have expensive assets that are fundamental to their operations, the value of the company's 'net assets' in the accounts is higher than a fair valuation derived using the normal formula. This can create an illusion of higher valuation for some sellers, especially when some experts write articles listing three, four or even more ways of valuing a company. This does not mean sellers can find the valuation basis that gives the highest valuation and expect to be able to market their company on that basis. Whatever the size of a company's overall net assets value, its market value will almost always be more closely linked to earnings and cash generation than the size of its balance sheet.

"Assets are great, but actual return is fundamental to most valuations."

As discussed earlier in this article each buyer is making an investment decision, so it follows that two similar companies generating similar earnings will, theoretically, have a similar valuation. Of course, a buyer might feel a high degree of comfort from buying a company with a 'heavy' balance sheet, but asking a buyer to pay more without the additional returns that should come from writing a 'bigger cheque' can be a challenge. Although not always an insurmountable one.



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SELLERS OFTEN KNOW BEST

I hope I've provided some useful building-blocks and an overview of the language and issues you will face when considering the valuation or sale of your company. It really isn't rocket science, though. Advisers can either help you or confuse you, but the reality is that you know enough about your own company to make an informed assessment of how it is likely to be valued.

> ***"Sellers usually know the true earnings and potential of their company and, therefore, its likely value in the market."***

IF YOU ARE CONSIDERING SELLING

Access to the right strategic buyers along with dedicated expertise to get a deal over the line requires an adviser with a truly global buyer network and the most professional and driven sell-side advisers in the business.

Please contact me, or any of my colleagues, if you have any questions, to request a valuation or to discuss how best to go about selling your company.

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