Valuation of Private Companies
Pitfalls and Best Practices

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Outline

Pitfalls

- Not differentiating between Price and Value
- Forgetting the basic valuation principles
- Misuses of Market Approach
- Misuses of Asset Approach
- Issues in the application of the Income Approach
- Missing the “Story”
- Not asking, does it make sense?

Best Practices

Fair market value

- The **highest price**, expressed in terms of **cash** and cash equivalents, at which property exchanges hands between a **hypothetical, willing and able** seller and hypothetical, willing and able buyer, acting at **arm's length** in an **open and unrestricted market** when **neither party has a compulsion** to buy or sell and both have **reasonable knowledge** of the relevant facts

Price

- The only true way to determine the price achievable for a business is to **expose it to the open market** and negotiate a transaction with another party

Pitfall #2 – Forgetting the Basic Principles of Valuation

Not understanding the basic principles of valuation:

- **Point** in time
- Value is **prospective** (i.e. not what the company DID, but what the company will DO)
- Personal goodwill is **not transferable**

Pitfall #3 – Misuse of Market Approaches

Guideline Public Company Method

- Does not consider **comparability** (e.g. size, depth of management, capital structure, ability to borrow, product/geo diversification)

Transactions

- Does not consider **comparability**
- Uses **dated** transactions and **a small sample**

Rules of thumb

- Use of rule of thumb as **primary valuation method**
  - Information about the companies that made up the rule of thumb are **not known**
  - Typically **ignore economic reality** of situation

Pitfall #4 – Misuses of Asset Approach

Cost Approach

- **Inappropriately applied**
  - Service businesses, asset light businesses, operating companies with intangible value
- Does **not consider future value** when significant intangible value exists

Pitfall #5 – Issues in the Application of the Income Approach

Discounted Cash Flow / Cap Cash Flow:

- Capitalized cash flow
  - **Not** maintainable
  - **Unsupported** projections
- Capitalization and Discount Rate
  - **Unsupported** rate
  - **Inappropriate** growth rate for terminal value
- Working capital / Redundancies **not considered**

Pitfall #6 – Missing the "Story"

Qualitative factors are not considered

- You cannot understand the Company without understanding **its story** (e.g. operations, risks, competitors, etc.)
- The qualitative story provides **support** for the valuation

Pitfall #7 – Not asking whether the conclusion “makes sense”

After the valuation is complete, a basic “sniff test” should be done

- At the end of the day, does the valuation conclusion make sense?
- Does it appear to be reasonable?
- Why or why not?

Best Practices

Consider multiple valuation approaches

- Asset approach – sets the lower limit
- Income approach – represents future value
- Market approach – used to get comfort on whether the answer is
    - 1st – **Plausible**
    - 2nd – **Supportable**
    - 3rd – **Reasonable**

Best Practices

Provide a story

- A **narrative (e.g. a memo/report**) to support your valuation calculations
- The narrative will help provide support for:
  - Valuation method
  - Adjustments
  - Assumptions
  - Analysis
  - Overall valuation conclusion

Questions?