How Privately-Held Businesses are Valued

Harris Northwest Advisors focuses on working with companies which have revenues of $10 - $250 million. This paper addresses valuation issues within this size range.

The first question any business owner considering a sale wants to know is: what is my company worth?

No two businesses are exactly alike, and a wide range of factors which affect valuation come into play for each specific deal. Also, because M&A transactions tend to take a lengthy period of time to complete, valuations can also be impacted by changes in the capital markets and the economy which occur between the start of the process and closing.

With those caveats in mind, below are the most important issues which determine valuation.

Profitability

The single most important valuation metric is annual cash profits. For investors, cash flow is generally referred to as EBITDA, or earnings before interest, taxes, depreciation and amortization.

Most deals for institutional-quality private companies in the $10 - $250 million range – where Harris Northwest Advisors specializes - generally fall within the range of 5-15 times EBITDA.

Size

Absolute size is a significant factor. There are three levels which are relevant:

- $2 million of annual EBITDA
- $5 million
- $10 million and higher

Everything else being equal, a business increases in value by about an additional 1-2x EBITDA as it surpasses each these levels. This due to several factors, including the perception of lower risk, a stronger foundation to the business, a greater investment into people and systems to professionalize operations, and greater upside.

Growth and Profit Margins

After cash flow, the growth rate of a business is usually the second most important factor in determining valuation. In general, investors place a disproportionately high premium on growth. In an economy where long-term GDP has increased at around 2-3% historically, companies which can expand

substantially faster than the overall economy command a premium. This investor preference for rapid growth is the primary reason why successful technology companies, for example, typically achieve higher valuation multiples.

The third most important factor is the gross margins. Similar to growth rates, higher margins generate greater interest from investors.

Other Valuation Factors

While EBITDA, size, growth rate and margins are the most important factors which drive value, there are other criteria investors consider. These include:

- Industry Outlook
- Market Share
- Level of Debt
- Historical Performance
- Regulatory Considerations
- Future Capital Requirements
- Technology and Other Intellectual Property
- Customer Concentration
- Quality of Management

Interest Rates and Cost of Capital

Low rates drive up the present value of future earnings, which helps fuel acquisition multiples upward., and higher rates have downward effect.

Summary

Valuation is part art, part science, and part timing. Generally, profitable private companies are in demand among well-funded buyers. However, the M&A process is complex and lengthy. Even in a favorable climate, significant time, effort and professional expertise is required to complete a successful transaction.

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