Indigenous Business Toolkit Project

Basics of Valuing a Business

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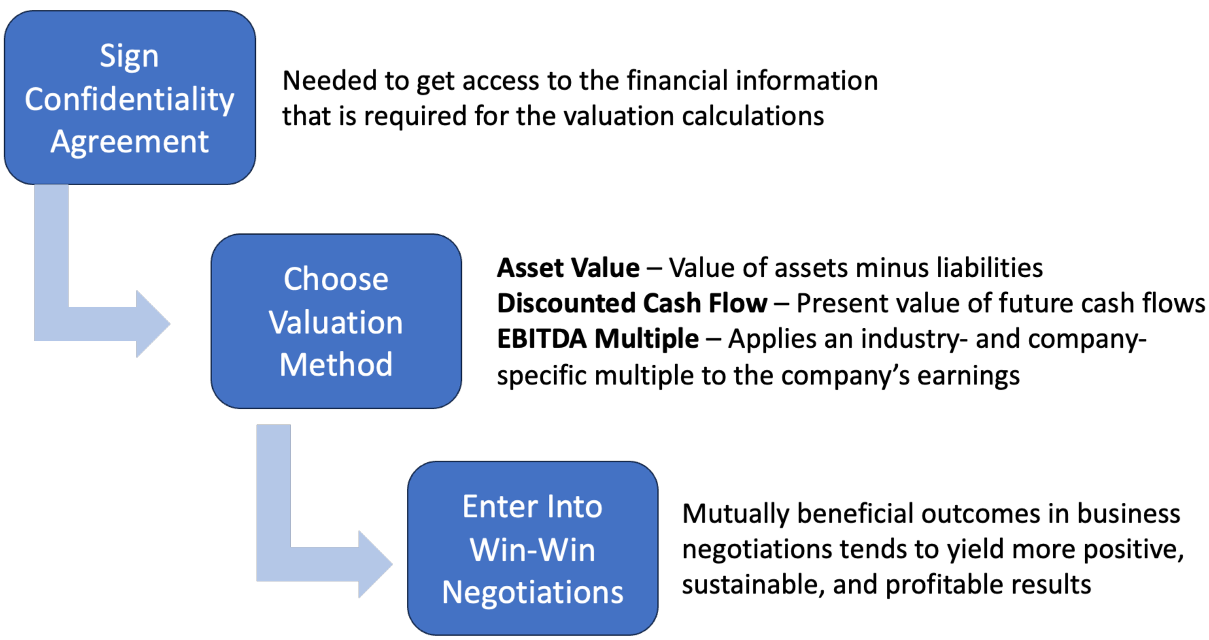
Summary

Business valuation is a critical step in the evaluation of an existing business, whether it is being sold or purchased. The goal of this module is to provide people such as board members with sufficient information on business valuation so they can be intelligent consumers of the business valuation information presented to them by others (e.g., management or consultants).

There are three primary valuation methods: Asset Value, or the value of assets minus liabilities; Discounted Cash Flow (DCF), which calculates the present value of future cash flows; and the EBITDA Multiple method, which determines a business's value by applying an industry- and company-specific multiple to a company's earnings.

Business valuation is more than mere price determination; it's a blend of analysis and negotiation aimed at understanding a business's true potential. Since business valuation almost always takes place in conjunction with the purchase or sale of a business, it is important to understand the need for a win-win approach in negotiations, one that is built on sustainable and ethical business practices.

Steps in Valuing a Business



Basics of Business Valuation

Determining the value of a business is a complex and nuanced process. Unlike items in a store, businesses do not have stickers that show the selling price. Moreover, the need for business valuation arises when the business is to be sold/purchased and the two parties to the sale/purchase have different objectives: the seller wants a high price while the buyer wants a low price. Thus, business valuation can be difficult to do and emotionally charged.

Valuing a business is not a negotiation or a haggling over price; instead, it is about determining what a business is worth. While business valuation isn't black and white, it isn't arbitrary either. This module explores ways to accurately assess a business's worth, emphasizing that despite the diversity in business types, financial profitability is a universal benchmark. Financial results, which are common to all businesses, form the cornerstone of business valuation. While they're not the sole factor, financial outcomes are nevertheless pivotal in determining a business's value.

Confidentiality Agreement

Business valuation requires access to the business's financial statements and to the highly confidential information that underlines them. Sellers won't readily share this information with just anyone, since doing so is likely to undermine their competitive position. To gain access to this vital but confidential information, the first step is for both parties to sign a Confidentiality Agreement (CA) or Non-Disclosure Agreement (NDA). These agreements ensure that the seller can safely share their confidential data, with the understanding that it will be kept confidential and used only for the agreed-upon purposes. Typically, buyers request three to five years' worth of financial statements to evaluate a business thoroughly.

Valuation Methods

There is no ideal method of valuing a business. However, there are three primary methods, each with its unique focus and applicability, as well as strengths and weaknesses. The choice of valuation method varies depending on the business type, industry, and valuation purpose, underlining that business valuation is as much an art as it is a science.

1. Asset Value – The asset value method calculates a business's worth by taking the difference between total assets and total liabilities. As the name suggest, this approach provides an estimate of the value of a company's net assets – i.e., the cost required to replace the assets. This valuation approach is relevant for asset-heavy industries like real estate or manufacturing.

2. Discounted Cash Flow (DCF) – The DCF method estimates the value of a business's future cash flows, discounting them to today's value. This method emphasizes the time value of money – i.e., that a dollar received today is worth more than a dollar that is received in the future – using an appropriate discount rate. The discount rate may also be adjusted to reflect risk attitudes.

3. Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) Multiple – The EBITDA Multiple method values a business by multiplying its historical earnings by a multiple that is specific to the industry in which the business operates. For example, if the EBITDA for a business is $10 million and the multiple is 5, then the business would be evaluated at $50 million (although the values of the multiple vary considerably, they typically range from 4.0 to 8.0). EBITDA Multiple is the most common method of valuing a business.

   The use of EBITDA allows analysts to focus on the company's ability to generate earnings from its core operations regardless of the business's financing structure (e.g., the amount of debt versus equity). The use of EBITDA also provides a picture of the cash that is being generated and that can be used to invest in property, plant, and equipment (whether for growth or maintenance). Finally, the use of EBITDA means that analysts can focus on pre-tax operating profitability, something that is important when comparing companies with different tax burdens.

Understanding the Going Concern Valuation Principle

The "going concern" principle assumes that the business will carry on operating and won't be shut down or sold off. Thus, the "going concern" principle focuses on the company's ongoing operations and its ability to make future profits – i.e., valuation is a long-term, forward-looking process, not one that looks at the value of the assets if they were to be sold right now.

Valuing a business on a "going concern" basis is difficult because doing so involves making judgements about how well the business will do in what is always an uncertain future. As a result, business valuations are always "wrong" in the sense that the real value, which is determined once future events unfold, is always different than what is calculated. Nevertheless, valuations can be better or worse depending on how well the analysis is able to capture the key aspects of future business environments.

Normalizing Earnings

Valuing a business accurately requires a clear and consistent understanding of operating costs and earnings potential. To obtain this view, earnings are normalized by filtering out irregular and non-operational elements.

The key steps in the normalization process include: (1) obtaining comprehensive financial records; (2) identifying and removing non-recurring items from the profit and loss statement; and making necessary adjustments related to owner-specific expenses, market-based considerations, and accounting practices like depreciation and amortization. These adjustments are vital for aligning the financials with industry norms and revealing the business's true profitability.

The documentation of the adjustments, along with their rationale, is critical since transparency is required for valuation discussions with stakeholders. The normalization process requires expertise in accounting, knowledge of the industry, and an understanding of market conditions. Adhering to generally accepted accounting principles and maintaining transparency throughout the process is essential for an accurate and credible business valuation.

EBITDA Multiple

Since EBITDA is relatively easy to calculate, EBITDA Multiple is often the go-to method of valuing a business. Choosing the right EBITDA multiple involves a careful evaluation of numerous factors, many of them unique to the specific business and its environment. Valuation is a blend of art and science, requiring a deep understanding of market conditions, industry standards, and the unique attributes of the business in question.

Industry norms significantly influence EBITDA multiples, with different sectors having different multiples. A company's size and market position are important; larger or market-leading companies often have higher multiples due to perceived stability and lower risk. Growth prospects and past performance are critical; businesses that have demonstrated strong growth or potential for expansion warrant higher multiples.

Economic and market conditions play a role, elevating or diminishing multiples based on the economic climate. Specific business factors like risk profile, capital expenditure needs, debt levels, and quality of earnings also affect the multiple. Additionally, the quality of management, the strength of customer and supplier relationships, the ownership of intellectual property, and geographical presence are considered in the valuation process.

Ownership transition is also a factor to consider. When an existing business is acquired, it is critical to understand what will happen to the management team – e.g., Will they stay on? Or will a new team be appointed? The status of the management team is extremely important, since the ability of a business to generate future earnings comparable to those in the past depends on the quality of the management team. If it is believed that management will not be as strong, then EBITDA needs to be adjusted downward, which in turn reduces the projected value of the business to the buyer.

One final thing to keep in mind when using EBITDA Multiple is the difference between enterprise value and deal value. Enterprise value is the company's total worth, encompassing equity, debt, preferred shares, and so on. Deal value is the transaction price in a sale and is influenced by negotiations, strategic value, tax considerations, and market conditions. Deal value usually involves backing out the business's debt from the price. It is transaction-specific, emerging from due diligence and may not align with theoretical valuations like enterprise value.

Implied Rate of Return

The value of a business calculated by EBITDA Multiple is often used in price negotiations. As a result, it is important to understand what the use of EBITDA Multiple means from the buyer's point of view. For example, buying a business at four times its EBITDA means it will take four years to recoup the investment if EBITDA remains constant; the rate of return on investment in this case is 25 percent. If the EBITDA multiple is five, then it will take five years to recoup the investment, with a rate of return of 20 percent.

Thus, from a buyer's perspective, the use of a lower multiple is advantageous, since it translates into a higher rate of return on investment. However, the seller will want to see the business sold at a higher multiple, since this means a larger purchase price (and a higher rate of return on their investment). Thus, negotiations over price translate into negotiations over the rate of return that the buyer and the seller can expect.

Win-Win Negotiations

In the business world, the choice between adopting a win-win or win-lose approach in negotiations can significantly impact long-term success and relationships. A win-win approach, where both parties benefit, is generally favored over strategies that seek to take advantage of the other party. This approach builds sustainable relationships, enhances business reputation, and encourages future collaborations. It fosters innovation, reduces post-deal conflicts, and reflects positively on internal company culture. In contrast, engaging in exploitative practices for short-term gains can lead to damaged relationships, reputational risks, legal challenges, and ethical breaches. Such practices may also provoke reciprocity, leading to similar treatment in future transactions, and can limit growth opportunities if parties feel exploited and exit the market.

Win-lose deals, where one party benefits at the expense of another, are not sustainable in the long run and carry significant drawbacks. They can lead to long-term losses, damaged trust and relationships, and a negative reputation. Ethical and legal implications are also a concern, as is the impact on market dynamics (e.g., the "losing" party might retaliate in future dealings).

Striving for mutually beneficial outcomes in business negotiations tends to yield more positive, sustainable, and profitable results. It's about creating shared value rather than focusing on one-sided gains. However, it's important to remain vigilant, as not all business players may adopt this ethical approach. Therefore, businesses must be cautious and prepared to navigate negotiations with parties who may not share a win-win mindset.

Indigenous Business Toolkit Project

The Indigenous Business Toolkit Project is designed to provide Indigenous communities and individuals with the practical tools they and their advisors can use to undertake successful economic development. Indigenous economic development is more successful when everyone – community members, community leaders, consultants, business professionals, employees, and/or potential partners – understands its many aspects.

The Toolkit provides step-by-step instructions on selected aspects of economic development based on the best practices of leaders in the field. The modules in the Toolkit cover everything from the role of economic development in nation building, to the importance of business charters, to the various legal forms that can be used to pursue economic development, to the steps needed to identify and negotiate beneficial partnerships, to the governance challenges that economic development must address.

The modules are available for free and for use by anyone. The full set of Toolkit modules can be found at: https://www.schoolofpublicpolicy.sk.ca/research-ideas/projects-and-labs/indigenous-leadership-governance-and-development-project.php.

The Indigenous Business Toolkit Project is part of the larger Indigenous Leadership: Governance and Development project designed to support long-term Indigenous economic development. In addition to the toolkit, the larger project involves capturing the economic development experience of Saskatchewan Indigenous communities through a series of case studies. The case studies, along with a description of the larger project, can be found at the website listed above.

Disclaimer

The information contained in this document is designed to provide an overview of a particular topic and should not replace legal and other expert advice. Groups wishing to use the concepts discussed should receive the appropriate professional advice necessary to ensure their specific goals and circumstances are considered and recognized.

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