BUSINESS VALUATION FOR SMALL AND MEDIUM-SIZED COMPANIES

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Due diligence and valuation techniques

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PREFACE

Value is subjective by definition. The aim of business valuation is to provide a rational framework as opposed to a predetermined and equally subjective quantitative value.

Both in literature and (valuation) practice, one observes a continuous unease with respect to the assessment of share value as well as total company value. On a daily basis, business valuation is practiced within a private, financial, and legal context. Although practiced with the best intentions and expertise, attempts at business valuation are usually founded on standardized formulas. Like all standards, these formulas are rather simplistic, accepted as mainstream standards, and have originated from a specific area of expertise.

The feeling of unease manifests itself when business valuation practitioners are asked to account for their application of standardized formulas in the case of customized valuations for privately owned companies. In such cases, both simple, standardized business valuation formulas and comparisons with stock exchange companies reveal their distinct shortcomings. Both the identity and dynamics of such companies, as economic entities, operational units, or individual economic instruments, are hardly incorporated in selected valuation methods, calculation of variables, and in assessment of both historical and future data.

The abundant Anglo-Saxon literature on business valuation is predominantly based on techniques for valuating stock exchange companies, which offers ample scope for case studies with impressive names and data sets. For companies that are not listed on the stock exchange, business valuation practitioners usually apply identical or derived techniques and data. In some cases, the value of a private company is simply assessed by referring to a similar stock exchange company and its associated share price. A recalculation based on equity structures of both companies results in the required valuation. The economical identity of the specific operational company rarely gets attention.

The European literature offers a number of classic methods for business valuation of private companies. These methods have been defined and applied over many years in both literature and practice. However, many professional business valuators still shy away from using these methods because of their static, sterile and out-dated formulas. Note that few people know that the method of discounted cash flow is one of the oldest formulas around.

In this book, we will demonstrate that such methods are only static and sterile if they are used in static and sterile ways. Any business valuation technique can be made more dynamic if the concept formula allows for inclusion of budgets, industry-specific variables and company-specific data. Such a dynamic application enables these methods to allow for incorporating forecasts, scenarios and statistics. In this way, the creative business valuation practitioner may 'customize business valuation' for private companies without having to refer to stock exchange companies. This is important for potential new owners, as company uniqueness gets more attention within the process of business valuation.

Increasingly, both literature and valuation practice include methods that are predominantly of a financial nature. Essentially, these methods revolve around valuation of long-term shareholder interests as opposed to (relatively) short-term stock value. These methods mostly focus on cash flow calculations and payback periods. In some instances, these methods also provide terminal values. For potential new owners that are only interested in financial prospects, it is indeed important that valuation include assessment of the company's financial potential.

It is also evident that detailed knowledge of companies in terms of economic entities should drive valuation. This is an essential requirement for valuation of private companies and companies that are not listed on the stock exchange. In such cases, potential new owners will focus on only one particular company or they will not be capable of trading company shares through the stock exchange.

Part I of this book is specifically dedicated to the analysis of the legal, financial and economical data and characteristics of the company that is to be taken over (to be referred to as '*target company*'). This analysis is widely known as due diligence. The list of due diligence specifics offers a guideline for conducting due diligence, as such a list can only be indicative. The goal of due diligence is to collect sufficient data for the financial basis of valuation as well as to attain a reasonable level of confidence of the completeness of the information regarding the takeover company. Due diligence can lead to propositions regarding financial status and budgets, to corrections concerning initial financial figures, and to specific clauses for inclusion in the final takeover contract. In practice, the due diligence list may either be too long or not sufficiently specific. This calls for a creative and analytical usage of the list.

We have also dedicated a separate chapter to mathematical techniques and variables that are used within various business valuation approaches. The idea is to provide the user of this manual with sufficient and exhaustive documentation on mathematical formulas and calculations. This chapter may, for some readers, reiterate familiar concepts. To other readers, this chapter will be a useful manual on business valuation calculations. Various techniques for budgeting growth forecasts will be discussed including scenarios and statistics.

In the part of the book on variables, we will consider the importance and calculation of interest rates and reference periods along with a calculation scheme to arrive at adequate estimations of variables discussed. In addition, we will comment on the approach to these variables that enable business valuation practitioners to make informed decisions on whether to increase (*surcôte*) or decrease (*decôte*) the value of these variables.

The 'valuation methods' part of the book illustrates a number of selected techniques. This section covers patrimonial approaches, profit calculations, formulas combining infrastructure, profit values as well as recent economic data, and added value based valuation techniques. Classic methods of business valuation have been re-vised to allow for usage of dynamic and customized data. In this way, these flexible methods incorporate fore-casts of annual figures including alternative variables, and if preferred, scenario applications and statistics. For techniques that are primarily focused on profit or cash flow, we sometimes offer terminal value as a realistic alternative to calculations based on infinite reference periods. The final chapter of this part includes a complete method that incorporates a multitude of various approaches and methods. It is up to the creative and analytical business valuation practitioner to select an approach or method that is most suited to the specific valuation assignment. In addition, we have included a specific component that allows for calculation of the added value for acquiring companies that are interested in embedding the takeover company into a complex corporate environment.

Inevitably, different approaches will yield different valuation results. It may happen that selected techniques will lead to different outcomes, even if the same calculations, set of variables and data have been used. Use of different approaches and formulas may lead one to conclude that one or more methods have resulted in exceptional outcomes. Rational analysis will often reveal why certain methods can be discarded as irrelevant in such cases.

Throughout this book, various business valuation methods will be illustrated with the help of the 'Target' case study. A second case study 'Concept' will demonstrate a limited and simplified application of business valuation. The business valuation practitioner is free to simplify these business valuation calculations by entering fixed interest rates, fixed variables, and so on.

In a separate chapter, we will discuss exceptional valuation situations. On the one hand, we will give a short description of specific valuation approaches for growing companies, financial firms, non-profitable firms, and complex, international conglomerates. On the other hand, comments will be provided on valuation issues concerning legal claims, purchasing agreements, management buy-out fees or management succession.

In the final chapter, we will discuss a method for valuation of shares of stock exchange companies. Although the focus of this book is primarily the valuation of private companies, we consider a description of these methods not to be superfluous. In many cases, one will be confronted with the application of stock exchange references and formulas relating to stock exchange companies as proxy for valuating private companies and companies that are not listed on the stock exchange. Although financial techniques for stock exchange analysis can be quite complex, business valuation techniques for stock exchange companies, such as the multiple calculations technique, can be described in rather more simple terms. In essence, it is not so much the application of the formula, but rather the selection and allocation of the reference periods and indices used in the application of the formula.

This book aims to address the lack of available literature on the due diligence process for obtaining data about individual companies. The book also aims to support a more dynamic application of existing formulas that have only been applied in a rather conservative way so far.

The lack of available literature implies that the bibliography of this book will necessarily be limited. Copying library lists would not offer any added value. For that reason, we have decided to limit the bibliography to a handful of historical references and recent sources for those readers willing to research these sources. Recent publications provide sound reading, but rely heavily on techniques for business valuation of companies listed on the stock ex-change and offer limited derivations for business valuation of companies that are not listed on the stock exchange. The internet offers an abundance of sources pertaining to business valuation. This book includes a number of these sites, because they offer new and interesting vocabularies, names and terms for existing business valuation concepts.

We hope this edition will support business valuation practitioners who find themselves in the midst of controversies regarding the assessment of company value. May this book offer them the arguments necessary to back up their positions.

Let me finish this preface by acknowledging Kaat and Hans for their patience and wisdom, and Aart for his writing and editing assistance with this manual. I dedicate this book to them. I hope that one day I can forgive myself for having embarked on the journey of writing this book.

The Author

CONTENTS