

## The basics of business valuation

This paper outlines some of the most useful tools that you need to build a picture of the likely value of a business. It doesn't try to be exhaustive, or scope out every scenario, but simply to outline the key issues that every business leader needs to understand.

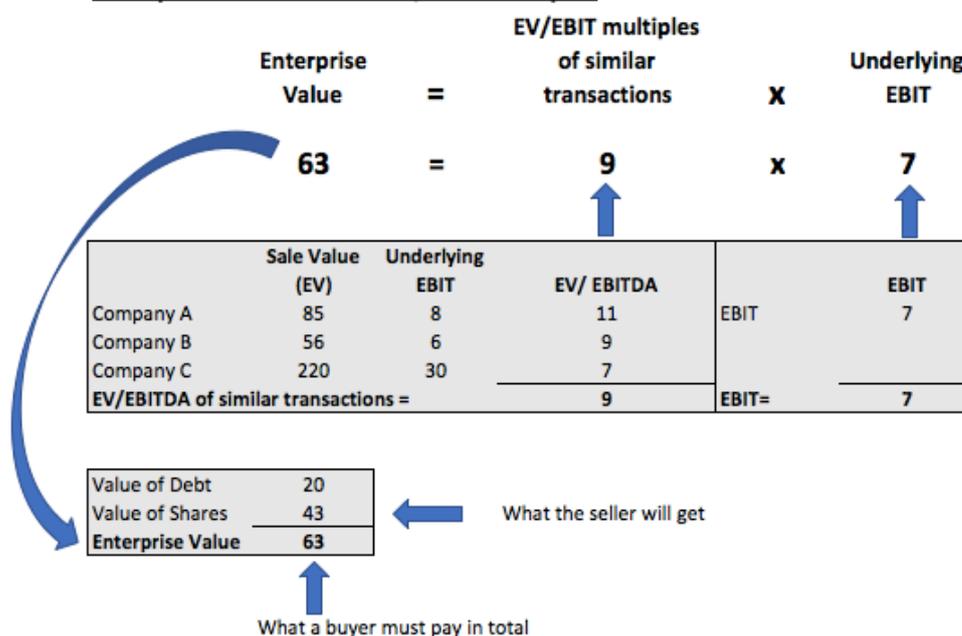
If you want to buy a house, knowing whether it is in a floodplain or a safe riverside setting will make all the difference to value. Similarly, the value of a business is dependent on several key factors including: what else is out there; how many buyers there are; what other 'synergies' can be generated to create value; and whether there are any special issues around the deal.

The most common valuation approaches that I have seen used when valuing businesses, are in: comparing similar transaction multiples; and discounting future cash flows. It is also at times appropriate to value a business on other measures such as asset value, customer base or turnover. The key tools are:

### EV/EBIT multiples.

Transaction values are often very similar for similar kinds of businesses, expressed as a proportion of the *underlying* operating profit made, so a useful starting point is to look at what other businesses have sold for, then apply those ratios to your own underlying EBIT. This measure is the simplest and is useful in the types of business where capital expenditure (and so depreciation) and amortisation charges are relatively low.

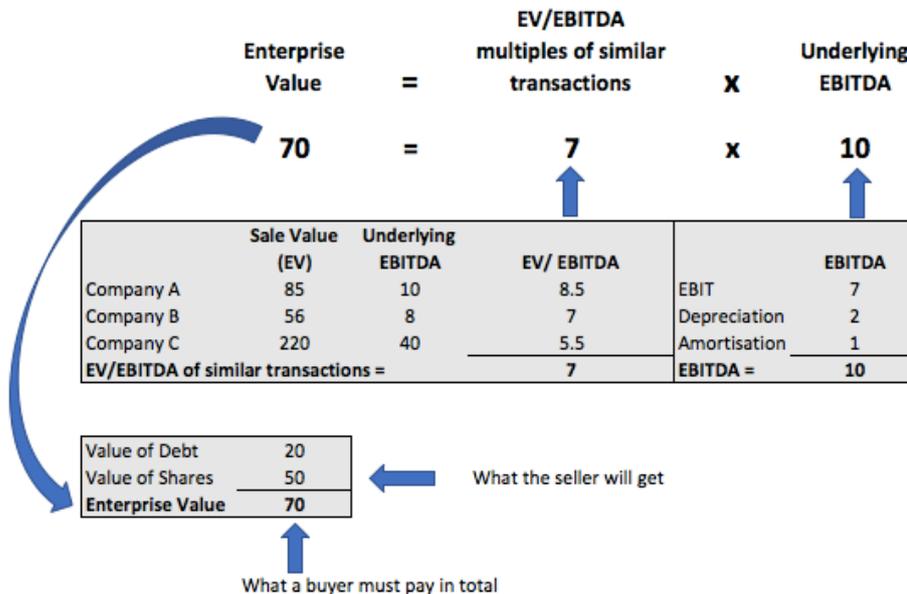
#### Example Valuation with EV/EBIT Multiples



## EV/EBITDA multiples

EV/EBITDA is the most common multiples approach used by investment professionals. Accounting policies vary by business, so adding back the depreciation and amortisation helps to make valuations more equivalent.

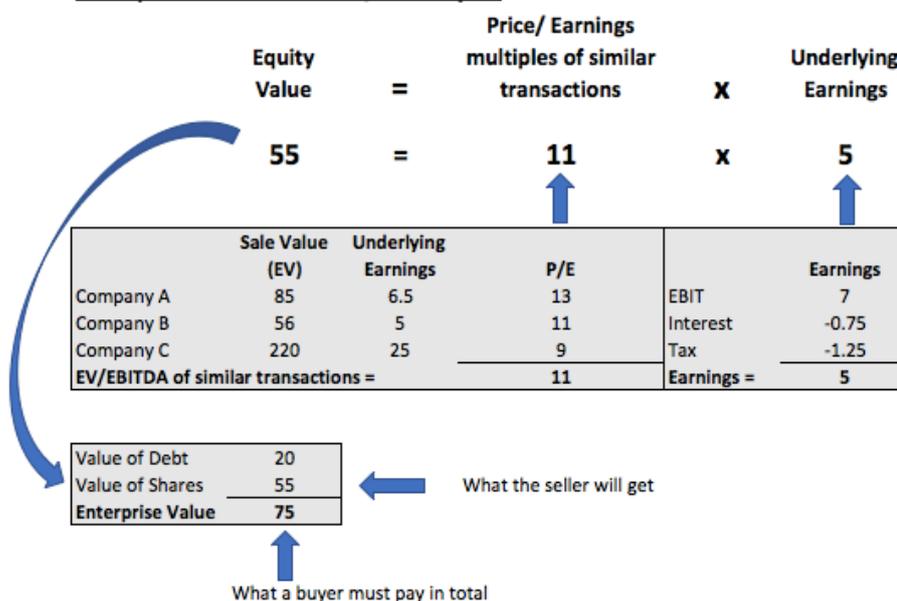
### Example Valuation with EV/EBITDA Multiples



## P/E multiples

Price/ Earnings multiples look at the value of the equity of the business compared to its earnings after interest and taxes. It is the classic stock market measure.

### Example Valuation with P/E Multiples



## Discounted Cash Flow (DCF)

DCF works by taking in all the projected future cash flows of the business, discounting them back to today. This approach was first invented by McInsey, the philosophy being that a pound in your pocket today is worth more than a pound will be in the future. To calculate DCF, you must predict future cash flows associated with generating the profits of the business over the next many years. Good luck with the crystal ball!

As the most technically involved of the measures, it compounds many factors, and so is much loved by the finance community. It allows easy comparison of different options and scenarios, albeit is greatly impacted by the assumptions made within the model, so beware of spurious accuracy.

### Example Valuation with Discounted Cash Flow

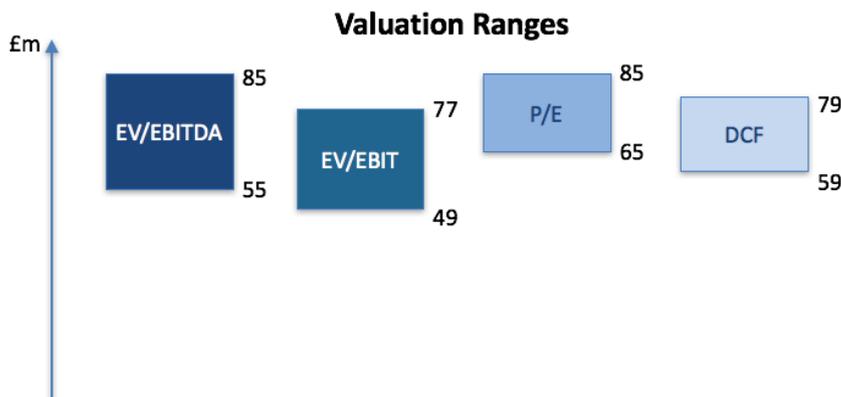
Year	Cash Flow	Discount	
		factor @	Discounted
		10% p.a.	Cash Flow
1	5	0.90	4.5
2	6	0.81	4.9
3	7	0.73	5.1
4	8	0.66	5.2
5	8	0.59	4.7
6	8	0.53	4.3
7	8	0.48	3.8
8	8	0.43	3.4
9	8	0.39	3.1
10	8	0.35	2.8
11	88	0.31	27.6
Total Discounted Cashflow			<b>69.5</b>

Disposal Year

← What the business is worth (EV)

## Valuation Ranges

Comparing the outputs from the valuation tools with varying assumptions paints the bigger picture of business value. Now that you understand what 'good value' looks like, you have a real basis for making decisions.



**Staffan Engström**