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The Issue of Reasonable Price for Private Companies

by Peter C. King, VR Business Sales/Mergers & Acquisitions, CEO

Valuing private companies is more difficult than valuing public companies because most private companies do not have audited financial statements, so a buyer has to spend considerable effort to dig out the accurate information on true earnings. Historically, closely held companies sell for "one-third" less than publicly held companies.

EBIT buyers, those who value sellers based on a multiple of EBIT, will not pay 5x earnings more or less for a company that is left as bare bones. The buyer will expect at least 50% or more of the purchase price to be supported by working capital and net tangible machinery and equipment. The buyer usually wants to buy a going concern particularly if he or she is paying full price. The buyer expects to be able to run the company without additional infusions for working capital or capital equipment.

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In analyzing what is a reasonable price to acquire a private company, one should scrutinize the seller's facilities list to assess its capital needs, and one should assess the adequacy of its working capital. In today's sophisticated marketplace, professional buyers are very pragmatic in that they generally do not substantially pay-up for "hockey-stick" type projections. Also, they want to be sure that the budgeted depreciation will exceed the necessary capital expenditures and that EBIT will hold up for the ensuing years.

A lot of discussions are based on current EBIT multiples, but just like price-earnings multiples of public companies, its relevance is often tied to the growth rate. One possible scenario for determining the EBIT multiple is the following analysis:

Growth Rate EBIT   10% 4—5   15% 5—6   20% 6—7

An above example is a theoretical approach to valuations, but in the real world, the buyers have to be very conscious of how the prices at which businesses are being bought and sold in the marketplace. Unfortunately, there are numerous solid and well-financed buyers, but excellent companies for sale are hard to find. Therefore, it is very difficult to buy companies at a reasonable price in today's market.

According to Howard Smith, Managing Director of Baldwin & Clarke Corporate Finance, Inc. of Bedford, New Hampshire, it is a myth to believe that growth for growth's sake is what drives the EBIT multiple upward. The real index for determining a reasonable price for a business is one's cost of capital. If the cost of capital exceeds the EBIT growth, then growth for growth's sake does not add value and does not increase the company's price. To compute the cost of capital; if a company's after-tax cost of debt is 6% and its estimated cost of equity is 16% and it plans to raise capital 20% by way of debt and 80% by way of equity, it computes the cost of capital at 14% as follows:

> The cost of equity is based on equity risk premiums published by Ibbotson Associates.
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> The Ibbotson analyses make extensive use of the rate-of-return data basis compiled by the Center for Research in Security Prices at the University of Chicago Graduate School of Business. In this case, the common stock annual total return (growth plus dividends) arithmetic mean is 12% plus a risk premium of 40%, which equates to a cost of equity of 16%.

Therefore, unless the EBIT is growing at a rate of greater than the 14% cost of capital in this example, many prudent corporate acquirers would not acquire the target company.

What does a multiple of earnings really mean? If we use a 5 multiple and divide it into 100, it inputs a return on capital of 20%. 7 multiple results in a 14.30% return, etc. Based on the risk reward considerations of buying and running a business, if you paid 10 times EBIT, your return would be 10% before tax, or approximately 6% after-tax, compared to a tax-free riskiness treasury currently 5.2%.

• Non-dependency on Few Suppliers

The above list is not complete, but it is the type of analysis that should be compared to or benchmarked with other companies. Of course, the market sets the price. In the real world, the seller usually settles for a lower price than originally desired, and the buyer pays more than originally expected. In valuations be careful not to place too much value on potential unless it is an earn-out. Most projections have the shape of the proverbial "hockey stick." Obtaining a reasonable price for private companies is undoubtedly one of the biggest challenges for buyers.

The problem with the above analysis is that we are in a strong acquisitions market. In order to buy a good company, an acquirer probably has to pay an "unreasonable" price. The alternative to buying good companies at inflated prices is to buy companies which are underperforming at reasonable prices (5x EBIT), and then "fix 'em."

Get out your checklist and see how the target company rates to the following questions:

- Stable Market
- Stability of Earnings Historically
- Realized Cost Savings After Purchase
- No Significant Capital Expenditures
- No Significant Competitive Threats
- No Significant Alternative Technologies
- Large Market Potential
- Reasonable Market Position
- Broad-based Distribution Channels
- Synergy Between Buyer and Seller
- Sound Management Willing to Remain
- Product Diversity
- Wide Customer Base

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