

\$49.00

# UNCHAINED ENTREPRENEUR

**HOW TO VALUE YOUR COMPANY FOR FINANCING OR SALE  
A STEP-BY-STEP GUIDE TO DETERMINING CORPORATE VALUATION**

What is my business worth?

Have you asked that question before?

Many business owners first ask that question when in the midst of a negotiation to take financing or sell their company. At that point, it may be too late. Determining valuation should be a relatively simple process, which you should engage in regularly – and **before** you begin to present to prospective investors or purchasers.

There are many methods for valuing a company: book value, assets, discounted cash flow, etc. In this guide, we will examine one particularly valuable method – Comparable Company Analysis (Comps). Not only will you discover what Comps are, but also you will learn the specific process and method for developing Comps for your own business. This guide will include the following:

<u>Topic</u>	<u>Page</u>
1. What is valuation?	3
2. Determinants of Valuation	4
3. Comparable Company Analysis	6
4. Comparable Transaction Analyses	32
5. Pre-Money vs. Post-Money	35
6. Presenting and Defending Valuation	37
7. Frequently Asked Valuation Questions	40

## WHAT IS VALUATION?

Valuation is nothing more than the process of determining how much a business (or other asset) is worth. In essence, it is similar to a real estate appraisal – placing a monetary value on the business for the purpose of sale or investment.

Of course, this process is more complicated than it seems. There are a number of methodologies used in determining valuation. This brief guide will describe how to value a firm using the Comparable Company method, as well as offer insights into how best to present and defend a business valuation.

## WHAT DETERMINES VALUATION?

In most cases, Valuation is determined by a combination of the historical and anticipated operational results of a business. Various factors play a role in determining value, and this guide is not designed to be comprehensive in nature. In developing basic valuations, you will need to need the following:

1. Historical Income Statements (if you have been in business more than 6 months)
2. Historical Balance Sheets (if you have been in business more than 6 months)
3. Historical Cash Flow Statements (if you have been in business more than 6 months)
4. Projected Income Statements
5. Projected Balance Sheets
6. Projected Cash Flow Statements

At this point you should stop reading this guide for a moment. Do you have these items? If not, it is imperative that you produce them – particularly items 4 -6. If you have difficulty producing comprehensive financial statements, you will need to find some assistance in that area prior to developing a valuation.

## WHAT DETERMINES VALUATION?

If you're not familiar with the term EBITDA, don't worry. EBITDA is actually fairly simple – it's simply defined as – **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization.

With that in mind, you can pre-calculate your historical and projected EBITDA as follows:

	Net Income (or Loss)	from your Income Statement
+	Interest Expense (if any)	from your Income Statement
+	Taxes (if any)	from your Income Statement
+	Depreciation (if any)	from your Income Statement or Cash Flow Statement
+	Amortization	from your Income Statement or Cash Flow Statement

All the components of EBITDA are thus readily available to you.

Note that it is possible to have a negative Net Income (a loss) and still arrive at a positive EBITDA. Also, it is possible you may not have any interest expense (no debt), taxes (you made no money), depreciation or amortization. That's OK – simply follow the calculations to get to your EBITDA.

# COMPARABLE COMPANY ANALYSIS

Comparable Company Analysis – “Comps” – have been used by investment bankers, private equity funds and venture capitalists for decades. Similar to real estate “comps,” this is a method for determining how publicly listed companies in similar industries are valued, in order to arrive at a projected valuation.

There are four primary components in developing Comps:

1. **Identify** publicly traded companies that have a business similar to your own.
2. **Gather** relevant financial statistics and key metrics for those companies.
3. **Calculate** valuation parameters using this data.
4. **Apply** this information to your own company’s financial data.

## COMPARABLE COMPANY ANALYSIS – IDENTIFYING COMPANIES

### A. Do you have any public competitors?

This is the easiest method for determining what companies to use in your comparable set. If you have (or can readily develop) a list of competitors, check to see if any of them are public companies. Open up Yahoo! Finance and type in the company names. If the company is currently listed, the dialogue box will show the name of the company and the exchange it is listed on.

Stay away from any companies that are listed as OTC BB or Pink Sheets.

### B. Use SIC data

SIC is an acronym for Standard Industrial Classification. The SIC sorts companies into categories based on the type of commercial and economic activity they are involved in. The best way to use this is to apply the Security and Exchange Commission's (SEC) SIC sort.

The SEC sort can be found at <http://www.sec.gov/info/edgar/siccodes.htm>.

Determine what SIC category applies to your business. Then you can go to the SEC EDGAR database. Once there, you can input the SIC (it's the 6<sup>th</sup> box down on the form) and it will return a list of SEC filers that operate in that classification.

Here is the EDGAR link <http://www.sec.gov/edgar/searchedgar/companysearch.html>.

## COMPARABLE COMPANY ANALYSIS – IDENTIFYING COMPANIES

Let's take an example. Say you operate a temporary employment agency. You examine the SIC classifications and find that your business operates in SIC 7361. After typing that in, you find a list of 32 companies that file with the SEC in that SIC classification.

Unfortunately, it's likely that all these companies are not useful for your purposes. Some of them may not be listed on a national exchange and some of them may no longer be ***current*** SEC filers. You need to do a little research – it's a bit time consuming but not difficult.

The best approach is to see if the companies are currently listed on the NYSE, AMEX or NASDAQ. You want to stay away from any companies listed on the OTC BB. As we did when looking for known competitors, open up Yahoo! Finance and type in the name of each company you want to review. If it is publicly listed, the dialogue box will show the name of the company and the exchange it is listed on.

To stick with our example, the first company listed for SIC 7361 is 51Job, Inc. When you start to type this in to Yahoo! Finance, it shows 51Job, Inc. is listed on the NASDAQ with a ticker symbol of JOBS. Make a note of the company name and ticker symbol and move on to your next candidate. In this case, the next company listed is Accufacts. When you type this into Yahoo! Finance, you don't get a matching company. Eliminate this candidate and move on.

## COMPARABLE COMPANY ANALYSIS – IDENTIFYING COMPANIES

Be careful with SIC classifications. The fact is, many of these categories are very broad. As such, just because you operate in the same SIC category doesn't mean that you are in the same business. You may have to do a bit of research.

Say that you run a business teaching English as a second language. After reviewing the SIC list, you determine that you operate in SIC classification 8200– Educational Services. You input that code into the SEC EDGAR database and it returns 118 companies. Great!

Not so fast. Educational Services can cover a range of business types. One company on the list is Devry, which clearly is not in the business of teaching languages. You need to examine each candidate to make sure that you are in a substantially similar business. Here's what to do:

After you determine if a company is listed on NYSE, AMEX or NASDAQ as noted above, continue and click on the company as it shows up in Yahoo! Finance. Then click on the profile tab on the left. You can then review the business summary for the company to see if is truly in a related business to yours.

## COMPARABLE COMPANY ANALYSIS – IDENTIFYING COMPANIES

### C. Get Creative.

In some cases, you will not be able to develop a list of companies that are in the exact same business space as yours. At that point, you need to stretch the boundaries a bit.

To begin with, you should review any company that is the same SIC class as your business and choose those that have substantially similar elements.

If you can't find any companies that seem similar in your SIC category, extend your search further. Try and find companies that address a similar customer base, operate in a field that is related to yours (perhaps they supply a complementary product, for example), use similar manufacturing techniques, etc. The goal, of course, is to develop a set of public companies that are as similar to your business as possible – the closer the better.

## **COMPARABLE COMPANY ANALYSIS – IDENTIFYING COMPANIES**

### ***How Many Comparables Do You Need?***

There is no set formula for the number of companies to use when producing Comps. In general, you want enough of a data set to prove meaningful and allow you to claim that the data is representative of industry valuations. One comparable is not particularly useful. Five comparables are good. Ten comparables are great.

However, too many comparable companies can also prove distracting – particularly if they are not all truly similar in nature to your business. It's probably best to find 5-10 comparable companies to use in your valuation analysis.

### ***How Do You Choose The Best Candidates***

If you're lucky enough to have a large group of qualified comparable companies, you'll probably need to eliminate some. The best way to make these choices is to always remember your goal – finding a data set that is as close as possible to your actual business.

As you evaluate the companies and their operations (particularly the financial data you'll review in the next step) be aware of points of congruency and difference. First eliminate companies whose business focus is not the same as yours, then review customer targets, selling approaches, gross margin percentages, number of employees, etc. One tip – if you have a large data set try and choose companies with smaller revenues (presuming you're not a large business) and market caps (since you're not currently a large, listed public company), as this creates even more similarity to your business circumstances.

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

Your next step is to gather the raw financial data for each company that you will need to use in developing your Comps.

It's best to do this on a spreadsheet, particularly because you will then calculate various ratios from the data. You will be gathering the information for each company in your comparable set:

### Current Information

Ticker Symbol  
Shares Outstanding  
Current Price  
Current Cash and Equivalents  
Total Debt

### Historical Information

12-Month Trailing Revenues  
12-Month Trailing EBITDA  
12-Month Trailing Net Income

### Projected Information

Projected Forward Revenues  
Projected Forward Net Income  
Projected Forward EBITDA

We will examine the process of gathering each of these data points

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

### Current Information

A. Ticker Symbol. As we discussed earlier, this can be obtained from Yahoo! Finance.

B. Shares Outstanding. Current shares outstanding can be obtained by using Yahoo! Finance.

After typing in the company name or ticker symbol, choose the “Key Statistics” option on the left side of the screen. The “Share Statistics” section on the right side will include the Shares Outstanding.

You can also obtain this by using the SEC EDGAR database at:

<http://www.sec.gov/edgar/searchedgar/companysearch.html> .

C. Current Price. Of course, this can be obtained from Yahoo! Finance.

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

- D. Current Cash and Equivalents. This can be obtained by using Yahoo! Finance.

After typing in the company name or ticker symbol, choose the “Balance Sheet” option on the left side of the screen. Be sure to choose “Quarterly Data” in order to get the most current information. Cash and Cash Equivalents should be the first line item on the balance sheet.

You should also add the “Marketable Securities” line item to this number.

You can also obtain this by using the SEC EDGAR database  
<http://www.sec.gov/edgar/searchedgar/companysearch.html> .

- E. Total Debt. This can be obtained by using Yahoo! Finance.

After typing in the company name or ticker symbol, choose the “Balance Sheet” option on the left side of the screen. Be sure to choose “Quarterly Data” in order to get the most current information.

Scroll down to the “Liabilities” section of the balance sheet. You should add together any line items that mention the word debt (current portion, short term, long term, etc.).

You can also obtain this by using the SEC EDGAR database  
<http://www.sec.gov/edgar/searchedgar/companysearch.html> .

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

### **Historical Information**

The idea with historical financial data is to obtain information from the most recent annual period – not merely the historical calendar period. Of course, you can simply use the most recent annual financial data – but the farther from the company’s fiscal year end you get the less accurate the comparable analysis would be. Thus, the standard approach is to use a trailing 12-month period.

- A. 12-Month Trailing Revenues. Historical revenues can be obtained by using Yahoo! Finance. You can either:
- i. Use the “**Key Statistics**” function on the left side of the screen. Revenues (ttm) is listed under the “**Income Statement**” section; or
  - ii. After typing in the company name or ticker symbol, choose the “**Income Statement**” option on the left side of the screen. Be sure to choose “**Quarterly Data**” in order to calculate properly. Add the total revenues from the four most recent quarters.
  - iii. You can also obtain this by using the SEC EDGAR database  
<http://www.sec.gov/edgar/searchedgar/companysearch.html> .

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

- B. 12-Month Trailing EBITDA. Historical EBITDA can be obtained by using Yahoo! Finance data. You can either:
- i. Use the “**Key Statistics**” function on the left side of the screen. EBITDA (ttm) is listed under the “**Income Statement**” section; or
  - ii. Choose the “**Income Statement**” option on the left side of the screen. Be sure to choose “**Quarterly Data**” in order to calculate properly. Make a note of Net Income, Income Tax Expense and Interest Expense for each quarter.  
  
Then, choose the “**Cash Flow**” option on the left side of the screen. Once again, be sure to choose “**Quarterly Data**.” Make a note of any Depreciation or Amortization line items under operating activities for each quarter.  
  
To finish, add Net Income, Income Tax Expense, Interest Expense, Depreciation and Amortization for each quarterly period to arrive at quarterly EBITDA.
  - iii. You can also obtain this by using the SEC EDGAR database  
<http://www.sec.gov/edgar/searchedgar/companysearch.html>

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

- C. 12-Month Trailing Net Income. Historical Net Income can be obtained by using Yahoo! Finance data. You can either:
- i. Use the “**Key Statistics**” function on the left side of the screen. Net Income Avl to Common (ttm) is listed under the “**Income Statement**” section; or
  - ii. After typing in the company name or ticker symbol, choose the “**Income Statement**” option on the left side of the screen. Be sure to choose “**Quarterly Data**” in order to calculate properly. Add the Net Income from the four most recent quarters.
  - iii. You can also obtain this by using the SEC EDGAR database  
<http://www.sec.gov/edgar/searchedgar/companysearch.html>

# COMPARABLE COMPANY ANALYSIS – GATHER DATA

## Projected Information

Valuation is not, in fact, a backward looking exercise. Historical data is used as a baseline for determining ongoing values, but the primary drivers of valuation are expectations in regard to future operations.

Unfortunately, projected financial information is often the most difficult to obtain. Here is how to go about acquiring the final components of your data set for comparable company analyses.

A. Projected Revenues. There are two methods for obtaining this:

- i. Yahoo! Finance. Choose the “**Analyst Estimates**” option on the left side of the screen. For many companies, you will find revenue estimates from financial analysts. Choose the average estimate of revenues for the following year.

Note that, strictly speaking, this method does not provide you a 12-month forward revenue projection, but a projection of revenues for the end of the company’s next fiscal year.

- ii. Brokerage firm. If you have a brokerage account, it is likely that you have access to free research reports. Most major companies have research following that will be available to you. Some of these reports will have more detailed analysis of the company you are reviewing, and may include individual quarterly revenue projections.

You can use quarterly projections (or a combination of quarterly and annual projections) to derive a 12-month forward revenue estimate.

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

B. Projected Net Income. Once again, there are two methods for obtaining this:

- i. Yahoo! Finance. Choose the “**Analyst Estimates**” option on the left side of the screen. For many companies, you will find earnings estimates from financial analysts. Choose the average estimate of earnings for the following year. Multiply the earnings estimate by the shares outstanding to arrive at projected net income.

Once again, note that this method does not provide you a 12-month forward Net Income projection, but a projection of Net Income for the end of the company’s next fiscal year.

- ii. Brokerage firm. Of course, as before if you have a brokerage account you likely have access to additional information. Many brokerage firms provide quarterly earnings estimates for major companies. Additionally, you can review individual research reports to find quarterly earnings estimates.

Be sure to multiply the earnings estimates by shares outstanding and add the resulting quarterly numbers to arrive at a 12-month forward net income estimate.

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

- C. Projected EBITDA. 12-month forward EBITDA is generally the most difficult of these items to obtain. If you have a brokerage account, you may be able to find a projected quarterly income statement in a research report that allows you to derive EBITDA.

If not, you can estimate your own 12-month forward EBITDA as follows:

- i. Calculate the historical quarterly Net Income to EBITDA ratio (divide your 12-month trailing Net Income by 12-month trailing EBITDA [Net Income / EBITDA]).
- ii. Divide 1 by the Net Income to EBITDA ratio.
- iii. Take your 12-month forward net income projection and multiply that by the number in step ii. This will give you a 12-month forward EBITDA.

This completes the process of obtaining data for your Comps.

## COMPARABLE COMPANY ANALYSIS – GATHER DATA

At this point, you should have a data set that looks something like the following:

<u>Company Name</u>	<u>Ticker Symbol</u>	<u>Price</u>	<u>Shares Outstanding</u>	<u>Cash</u>	<u>Debt</u>
Amazon.com	AMZN	\$ 132.80	432.98	4,001	116
<u>Revenues</u>	<u>Historical EBITDA</u>	<u>Net Income</u>	<u>Revenues</u>	<u>Projected EBITDA</u>	<u>Net Income</u>
21,692	997	743	29,074	1,336	996

\* All numbers except price in millions

This example uses Amazon.com as a comparable. Realize that these numbers (with the exception of the price) are all in millions. You will need to adjust the scale used dependent on your particular data set.

Please note this is for illustrative purposes only and the specific derivation of this data is not shown in this Valuation Guide.

## COMPARABLE COMPANY ANALYSIS – CALCULATE METRICS

You are now equipped to move to the next phase of the comparable company analyses process – determining the valuation multiples in the public market for your data set. As a result of the data gathering you have performed, this process will be relatively simple. The core steps will include:

- A. Calculating equity market capitalizations for each company
- B. Calculating market enterprise values for each company
- C. Calculating historical valuation multiples for each company
- D. Calculating estimated valuation multiples for each company
- E. Analyzing multiples

## COMPARABLE COMPANY ANALYSIS – CALCULATE METRICS

- A. Equity Market Capitalization. Market capitalization refers simply to the total dollar market value of all of a company's outstanding shares. You can readily calculate this as follows:

$$\text{Price} \times \text{Shares Outstanding} = \text{Market Capitalization}$$

- B. Enterprise Value. Enterprise Value (EV) is an important concept in valuation analysis. EV represents the entire economic value of a firm. Essentially, EV is designed to measure the theoretical cost that a buyer would incur in order to purchase the entire company.

Whereas Market Capitalization values a firm's equity, EV adjusts the value for certain liabilities (debt) and assets (cash). If a buyer were to purchase a firm, he would have to assume (or pay) all of the debt on the corporation's books. Of course, the buyer would also receive any cash and equivalents held by the acquisition target.

Thus, EV measures the value of equity plus debt adjusted for cash. You can calculate Enterprise Value using your data set and Market Capitalization as follows:

$$\text{EV} = \text{Market Capitalization} + \text{Debt} - \text{Cash \& Equivalents}.$$

## COMPARABLE COMPANY ANALYSIS – CALCULATE METRICS

C. Historical Valuation Multiples. There are three primary multiples you will use in reviewing market valuations:

- Market Capitalization / Net Income (this is the same as the Price / Earnings multiple);
- EV / Sales; and
- EV / EBITDA.

Calculating these multiples is straightforward:

- Market Capitalization / trailing 12-month Net Income;
- Enterprise Value / trailing 12-month Sales; and
- Enterprise Value / trailing 12-month EBITDA.

D. Calculating Projected Valuation Multiples. In a like fashion, you can calculate the relevant future multiples:

- Market Capitalization / projected 12-month Net Income;
- Enterprise Value / projected 12-month Sales; and
- Enterprise Value / projected 12-month EBITDA.

## COMPARABLE COMPANY ANALYSIS – CALCULATE METRICS

- E. Analyzing Multiples. Before proceeding with analyzing the results of your calculations, you should add a few statistical manipulations. For each category of valuation multiple, you should determine the average (mean), minimum and maximum multiples. You should now have something similar to the following:

<u>Company Name</u>	<u>Ticker Symbol</u>	<u>Price</u>	<u>Market Cap</u>	<u>Enterprise Value</u>	<u>EV / Sales</u>	<u>Historical EV / EBITDA</u>	<u>MC / NI</u>	<u>EV / Sales</u>	<u>Projected EV / EBITDA</u>	<u>MC / NI</u>
Allied Healthcare	AHCI	\$ 3.01	\$ 135.42	\$ 101.76	0.40x	5.52x	13.20x	0.37x	4.84x	11.58x
Almost Family	AFAM	\$ 37.13	\$ 339.74	\$ 334.46	1.17x	8.08x	14.74x	1.02x	7.34x	13.40x
Amedisys	AMED	\$ 39.37	\$ 1,100.79	\$ 1,278.85	0.88x	5.18x	8.85x	0.76x	4.58x	7.81x
Chemed Corp	CHE	\$ 45.62	\$ 1,029.19	\$ 1,137.64	0.96x	7.08x	13.06x	0.93x	6.72x	12.40x
Gentiva Health Services	GTIV	\$ 24.67	\$ 723.08	\$ 836.18	0.71x	6.55x	11.42x	0.65x	6.64x	11.58x
LHC Group	LHCG	\$ 31.36	\$ 578.59	\$ 580.69	1.16x	6.66x	13.80x	0.99x	6.29x	13.07x
Average					0.88x	6.51x	12.51x	0.79x	6.07x	11.64x
Minimum					0.40x	5.18x	8.85x	0.37x	4.58x	7.81x
Maximum					1.17x	8.08x	14.74x	1.02x	7.34x	13.40x

This example addresses home healthcare businesses. Please note this is for illustrative purposes only and the specific derivation of this data is not shown in this document.

With this in hand you can begin to analyze the data to determine (a) what is the most appropriate valuation multiple to utilize and (b) is there any reason to eliminate any of the comparable candidates?

## COMPARABLE COMPANY ANALYSIS – CALCULATE METRICS

### ***Choosing an Appropriate Valuation Multiple***

There is no set formula for determining which of the multiples (EV/Sales, EV/EBITDA or Market Cap/Net Income) should be used when valuing a firm. You should review the multiples to see if there is any evidence of “clustering” in the multiples.

Clustering is when you find that many of the candidates have multiples near one another. In our example, there is a great deal of variation in the EV / Sales and Market Cap / Net Income multiples. The EV / EBITDA multiples, however, are relatively congruent. This suggests that the EV/ EBITDA multiple will be most appropriate for valuing your home healthcare business.

### ***Eliminating Outliers***

In some cases, you will find that one or two companies have multiples that are significantly different than their peers (either on the high or low side). In those instances, it is usually best to eliminate the outliers (unless that would leave you with too few comparable companies). Note that the outlier analysis should only be applied to the valuation multiple that you have determined is relevant.

In our example, Allied Healthcare has a very low EV/ Sales multiple – but we are using EV / EBITDA, and it is not even the company with the lowest EV / EBITDA multiple. It is not a candidate for elimination.

## COMPARABLE COMPANY ANALYSIS – APPLYING RESULTS

Now that you've determined industry valuation multiples, it's time to apply the information and come up with a valuation for your own company. The process for this is quite simple – you merely take your historical and projected financial data and apply the industry multiples in order to come up with the value for your enterprise.

Let's create an example to make this as easy as possible. We'll assume that you run a home health care company with the following attributes:

Trailing Twelve Month Revenues:	\$ 2,360,465
Trailing Twelve Month EBITDA:	\$ 319,415
Trailing Twelve Month Net Income:	\$ 181,660

Let's also assume that you have a substantive growth plan and accompanying financial projections with the following data:

Projected Twelve Month Revenues:	\$ 4,130,814
Projected Twelve Month EBITDA:	\$ 495,698
Projected Twelve Month Net Income:	\$ 309,811

## COMPARABLE COMPANY ANALYSIS – APPLYING RESULTS

This information allows you to produce the following valuation matrix, using the Enterprise Value / EBITDA multiples:

	<u>Multiple</u>	<u>Valuation</u>
Average Historical	6.51x	\$ 2,079,685
Minimum Historical	5.18x	\$ 1,655,652
Maximum Historical	8.08x	\$ 2,579,845
Average Projected	6.07x	\$ 3,008,614
Minimum Projected	4.58x	\$ 2,268,054
Maximum Projected	7.34x	\$ 3,640,556

As you can see, this provides a valuation range of \$1.66 million to \$3.64 million, utilizing both historical operations and your future projections. You could also produce this matrix for the other multiples should you desire.

# COMPARABLE COMPANY ANALYSIS – APPLYING RESULTS

## *Other Metrics*

You should be aware that your industry may have other metrics of valuation: number of subscribers, units deployed, etc.

By reviewing company filings on the SEC EDGAR database and reviewing research reports, you can often find historical (and future) data regarding these key metrics. The SEC database link is: <http://www.sec.gov/edgar/searchedgar/companysearch.html>.

Create additional fields for the key industry metrics and then utilize the data in calculating an Enterprise Value ratio through dividing EV by the key metric.

## COMPARABLE COMPANY ANALYSIS – APPLYING RESULTS

### *Using the Highest Valuation Multiples*

When reviewing your Comps, it becomes immediately evident that certain companies achieve higher valuation multiples than others. Obviously, it would be to your advantage to justify applying the highest multiple (rather than the average) to your company's financial data when calculating valuation.

It is possible to create a rationale for using the higher multiples, dependent upon your operations. This process does require a bit more work, but not much.

When reviewing the financial data in your comparable data set, take a look at the efficiency of operations for each company. The best way to do this is by using gross margin (which you can find in the Income Statement), EBITDA and Net Income as a percentage of revenues. Calculate these percentages for each company in your data set. Then review the results to see if those companies with higher ratios (more efficient operations) receive larger valuation multiples.

Sometimes this will prove inconclusive (as in the home healthcare example). Other times, strength one (or more) of these ratios may be clearly associated with higher valuation multiples. When this is the case, apply the same test to the financial data from your own company. If your ratios are equal to (or higher) than the leading companies in your data set, you have a justification for utilizing the higher multiples in your valuation. Be sure to note this when presenting your valuation.

## COMPARABLE COMPANY ANALYSIS – APPLYING RESULTS

### *Private Discount Effect*

Be aware, that many professional investors will invest at a discount to the multiples derived in from comparable company analysis. One primary reason for this involves liquidity. An investor in a public company (generally) is able to sell the stake quite easily in the public markets. No such exit is available to private company investors. Thus, a discount to the public market valuation is often applied when investing in private companies. When attempting to counter this argument, there are two key points to be aware of:

1. If you are an early stage firm, your valuation is based on (at best) financial projections from your next fiscal year. It is possible that your significant growth will occur in year 2 or year 3. As such, this methodology effectively understates your valuation, since it does not account for the substantive operational growth anticipated in the near future. Accordingly, there should be no adjustment applied for lack of liquidity.
2. If you are seeking investment that would result in the sale of more than 50% of your company, then a control premium should be applied to the valuation. A control premium is the amount a buyer is typically willing to pay over the market value when purchasing a company. Depending upon the industry, control premiums range from 20%-30% above market value. If applicable, a control premium should be sufficient to counter any private market discount arguments.

## COMPARABLE TRANSACTIONS ANALYSIS

The same methodology used for comparable company analysis can be used in analyzing comparable transactions. This approach is often more closely aligned with private company valuations. It does, however, require more time and energy – and does not always result in success.

Essentially, you will be using public announcements and SEC filings to find when firms in your industry have been acquired by public companies. By identifying these transactions, and finding relevant transaction terms along with financial data of the acquired firms, you can develop a valuation based upon these acquisitions. Here are the steps:

1. Identify Transactions. There are two primary methods for identifying acquisitions of companies in your industry:
  - a. News. Scroll back through the news (in Yahoo! Finance or any other service) for each company in your comparable company data set. Material acquisitions are a matter of public record, and most companies announce acquisitions in a press release. Make a note of the dates of the acquisitions. Once you have this information, find the 8-K filings (see below) for these transactions.
  - b. SEC. Material acquisitions (and press releases) must be disclosed to the investing public via the SEC. This disclosure is completed via the filing of a form 8-K.

Unfortunately, 8-K filings are used for many disclosure items – not simply acquisitions. One method of identifying acquisitions is to use the SEC EDGAR database to scroll through a company's filings for the last 12-18 months and look at each 8-K filing. Here is an example of an 8-K filing announcing an acquisition

[http://www.sec.gov/Archives/edgar/data/717724/000114420409034230/v153258\\_8-k.htm](http://www.sec.gov/Archives/edgar/data/717724/000114420409034230/v153258_8-k.htm).

## COMPARABLE TRANSACTIONS ANALYSIS

2. Obtain Data. You must now obtain data in regards to (i) the terms of the transaction and (ii) financial operations of the acquisition target. The data can be obtained as follows:
  - a. Terms of transaction. Often the terms of the transaction are set forth in the initial 8-K filing. You may need to do some calculations, as these transactions often involve the issuance of stock in addition to (or instead of) a cash payment. If you do not readily find this information, you can determine it using the next step.
  - b. Financial Data. If an acquisition is “material” in nature, the acquiring company must file financial data on its target with the SEC. In our previous example (Step 1b), the 8-K filing noted that the financial data would be set forth in an S-4 filing. Sometimes the data will be made available in a subsequent 8-K filing.

You need to find the subsequent filing in the SEC EDGAR database and review the financial data. Make a note of all the same historical financial data that you obtained when performing a comparable company analysis.
3. Calculate Valuation Metrics. You can now proceed to calculate valuation metrics as you did when performing your comparable company analysis.

Note that for market capitalization, you can use the aggregate value of the acquisition and for Enterprise Value you can use the aggregate value of the acquisition + debt of the acquired company (unless the terms specifically exclude assumption of the debt) – cash and equivalents of the acquired company.

## COMPARABLE TRANSACTIONS ANALYSIS

4. Apply the Data. You can now apply the resulting valuation multiples to your company, as you did previously when performing your comparable company analysis.

Be aware, comparable transactions analysis are more difficult than standard comps and the effort may prove unsuccessful. You may find that there are not enough announced acquisitions in your industry to merit using this method. Even if you do find announced acquisitions, you may be unable to find the needed financial data (if an acquisition is not “material,” the financial data will not be disclosed).

Nonetheless, if you are able to produce a comparable transactions analysis data set, you likely have an even more appropriate method for measuring the value of a private company.

## PRE-MONEY vs. POST-MONEY

One source of confusion in the capital raising process that often arises for non-finance professionals involves the terms “pre-money” and “post-money” valuation. Although the terms may appear straightforward to some, it is worth reviewing the definitions, differences and applications of these two concepts.

**Pre-Money Valuation**, as the term implies, refers to the value of the firm prior to investment.

**Post-Money Valuation**, therefore, references the value of a company after an infusion of capital.

These terms may not seem confusing to you. Unfortunately, it is the jargon and application in practice that can often bewilder entrepreneurs seeking capital.

This can be best demonstrated via an example. Let’s assume the following:

- You are the founder of a social community business for surfers in need of growth financing. You are the sole owner of the business and there are 100,000 shares outstanding (held by you).
- An angel investor group enthusiastically offers to provide you with \$1,000,000 of capital for expansion. You perform a comparable company analysis and determine the value of your business is \$3,500,000. After a series of negotiations, you and the angel investor group agree to a \$3,000,000 valuation. The group’s lawyer draws up a stock purchase agreement for your review.
- As you examine the document, you discover that it calls for the investment of \$1,000,000 in return for the issuance of 49,254 new shares. Is this correct?

## PRE-MONEY vs. POST-MONEY

Well, it depends. When you had your negotiation with the investor group, did you agree upon a pre-money or post-money \$3,000,000 valuation?

If you were referencing a pre-money valuation, then the \$1,000,000 investment would own 25% of the post-transaction shares outstanding, calling for the issuance of 33,333 new shares (this would result in 133,333 total shares outstanding, 33,333 of which were owned by the investor group. This can be calculated as follows:

$\$3,000,000 \text{ pre-money plus } \$1,000,000 \text{ investment} = \$4,000,000 \text{ post money};$

$\$1,000,000 \text{ investment} / \$4,000,000 \text{ post-money} = 25\% \text{ ownership}$

Of course, if you agreed on \$3,000,000 post-money, then the investor group's lawyer was correct

$\$1,000,000 \text{ investment} / \$3,000,000 \text{ post-money} = 33\% \text{ ownership (49,254 shares issued to investor group of 149,254 shares total)}$

This, of course, would mean that your effective pre-money was only \$2,000,000.

Always be certain you are discussing pre-money valuation when negotiating investments. In order to determine the final capitalization of the company, simply take the proposed investment and divide it by the sum of the agreed upon pre-money valuation plus the proposed investment. This is percentage ownership of the company that an investor should end up with.

One final point – be aware that your valuation methodology can sometimes force you into a post-money discussion. If you choose to use the valuation multiples based off of your future projections **and** you require financing in order to achieve those projections, then an investor may rightfully point out that your valuation should actually be post-money.

## VALUATION PRESENTATION AND DEFENSE

Now that you have finished your analysis and understand the basics of this process, you will need to prepare yourself to demonstrate your company's valuation.

1. Set forth the data that you have gathered and calculated in chart form. Be prepared to describe the process you used and explain why you chose the company's in your data set and which valuation metrics are most appropriate (and why).
2. Present (or review if you have already presented) the key historical and projected financial data for your company.
3. Show the valuation matrix for your company, applying the data from steps 1 and 2 – describe why the multiples you have chosen are appropriate. Emphasize any points regarding your operations that place it in the "elite" group of comparable companies.

Once you have finished presenting your valuation, be prepared for questions and challenges. These will fall into two broad categories: challenges to your valuation methodology and challenges to your financial data.

# VALUATION PRESENTATION AND DEFENSE

## ***Valuation Methodology Challenges***

If you have followed this process diligently, it is likely that questions in this area will not be insurmountable. Some investors may question your choices of companies or challenge your decisions regarding which multiple is appropriate. Be sure to listen to any question or challenge and then politely marshal support for your position. This is where conversations regarding discounts are likely to arise, so be certain to review the counters to the private market discount from page 31.

Remember, however, that it is not about being “right.” Final valuation decisions are unlikely to be decided at the table based on your analyses, so be careful not to over argue your position.

## ***Financial Data Challenges***

In any substantive valuation discussion, this is likely to be the area where more focus is devoted by prospective investors. Your valuation methodologies, if you’ve followed this guide, are unlikely to collapse under scrutiny. The financial data, particularly your projections, is another matter. Although we can arm you with the tools of valuation methodology, they are still contingent upon a defensible set of financial data. You will need to be fully conversant with your historical and projected financial statements and prepared to defend them in great detail.

# VALUATION PRESENTATION AND DEFENSE

## *The Golden Rule*

There is a cliché in the financing world – “he who has the gold rules.” Remember this as you present and negotiate valuations. The valuation methods that we have examined here are by no means comprehensive. Many investors use far more complicated (multi-factor econometric models with correlation adjustments) or far simpler (“4 to 5 times trailing EBTIDA – that’s our valuation parameter”) approaches. To a certain extent, there is only so much you can do to affect the valuation decision of an investor. Your job is to demonstrate that you have taken the time to develop a proficiency with valuation methods and present an option for how you believe your company should be evaluated.

**Good Luck!**

## FREQUENTLY ASKED QUESTIONS ABOUT VALUATION

### ***Isn't all valuation just discounted cash flow?***

Discounted Cash Flow (DCF) analysis is a traditional valuation method. It is used in academic settings and to value larger, established companies, as well as companies in the public markets. Many investors do not rely on DCF when evaluating smaller, private growth firms for investment or purchase.

### ***Won't this method undervalue my company?***

The method used here evaluates a company based on financial operations for the year past and the coming year. For companies in the early phase of their life cycle, this can result in a low valuation. One way to address this issue is to use financial projections from 2 or even 3 years in the future (instead of 1 year) and then apply some form of discount to the resulting valuation.

### ***What does the term EBITDA mean?***

EBITDA refers to a calculated value on a company's income statement. EBITDA can be calculated by taking Net Income and adding back Interest Expense, (federal, state and local income) Taxes, Depreciation and Amortization. EBITDA is essentially a proxy for the operating cash flow of a company.

## FREQUENTLY ASKED QUESTIONS ABOUT VALUATION

### ***My company has negative EBITDA, how can I use this methodology?***

First, be certain that EBITDA is the appropriate valuation metric. You may operate in an industry that is valued on a multiple of sales. If not, and your company has a negative EBITDA (which means you are operating at a loss), you will need to refer to your financial projections. If your financial projections presume a positive EBITDA in the coming year, you can proceed as detailed in this guide. If, however, you do not expect a positive EBITDA for the next fiscal year, you will need to make adjustments. One solution is to use financial projections from 2 or even 3 years in the future (instead of 1 year) and then apply some form of discount to the resulting valuation. You may want to explore alternative methods for valuing your company. Be aware that investors may not have confidence that you can achieve positive EBITDA if the target date is too far in the future.

### ***OK, but I don't have any sales yet, now what do I do?***

Once again, you can use this methodology. The solution is to refer to your financial projections. If your projections for next year still call for no sales, then you will need to look to further year projections and apply a discount. If your business plan projects no (or minimal) sales for a number of years to come, it is possible that a different metric (readership, user base, etc.) may be a more appropriate method for valuation. In either case, you may want to explore alternative valuation methods.

## FREQUENTLY ASKED QUESTIONS ABOUT VALUATION

### ***What is Enterprise Value?***

Enterprise Value (EV) represents the entire economic value of a firm. Essentially, EV is designed to measure the theoretical cost that a buyer would incur in order to purchase the entire company. EV adjusts the value for certain liabilities (debt) and assets (cash). If a buyer were to purchase a firm, he would have to assume (or pay) all of the debt on the corporations books. Of course, the buyer would also receive any cash and equivalents held by the acquisition target. The formula is  $EV = \text{Market Cap} + \text{Debt} - \text{Cash}$

### ***Why is Pre-Money and Post-Money important?***

These terms are key when determining how much of the company you give up when taking financing. When calculating how much of the company is sold (dilution), you should be applying the following formula:  $\text{Investment} / \text{Post-Money Value}$ . Of course, Post-Money Value should be calculated as  $\text{Pre-Money Value} + \text{Investment}$ . You can use this information to calculate an effective pre-money valuation if someone offers you financing. Simply take  $\text{Investment} / \% \text{ sold}$  to obtain the Post-Money Value.  $\text{Post-Money Value} - \text{Investment}$  would then tell you the effective Pre-Money Value. You can then compare this to your valuation analysis to determine whether it is in line with your expectations.