BIZ Advisory Board
Growth Champions

Article ArC010 – Company Worth and Evaluations
Category: BtoB

Overview

There are several methods of evaluation to determine the value of a business. How your company is evaluated determines *how and who* you approach for financing or selling. The two most common methods are Equity and Discounted Cash Flow (DCF) valuations.

Equity "Asset" Value. The equity value (or net asset value) is the value that remains for the shareholders after any debts have been paid off. This evaluation considers assets like property, inventory, and financials (accounts receivables, cash in reserves and on-hand).

When raising capital—when the individual business assets are "not enough"—lenders and investors require owners' personal guarantees as well as assets from the business owner as additional collateral. Traditional banks, private equity firms, and venture capital companies can provide the needed investment.

Advantages

- This evaluation will attract the most attention. You are making money with an existing product, have proven sales, and many more in the sales pipeline.
- Caters to organizations with hard physical assets to include inventory, AR, land, and buildings
- When growth rate has been good over the past few years.

Disadvantages

- Lack of consideration of future sales
- Technical solutions and Software as a Services are greatly underserved.

DCF Value. Discounted Cash Flow forecasts the company's unlevered free cash flow: future cash. In this case, a reasonable prospectus (financial forecast), including past performance (if available) of similar organizations, is imperative.

Advantages

- Intrinsic value of equity can be justified
- Relies on free cash flows rather than accounting figures
- Different variations of the model account for different growth rates (e.g., multistage models)
- Maximizes evaluations for organizations that produce Monthly Residual Revenue (MMR)

Disadvantages

- Based on assumptions on inputs (growth rate, required return on equity, and future cash flows)
- Difficult to forecast cash flows in cyclical businesses

The DCF value is often used with technology companies, particularly those with a great innovative idea and those that have the organizational team to develop the idea and bring it to market. Perfect examples of this are Facebook and Amazon.

When raising capital for a DCF validation, traditional equity value is, of course, looked at, but DCF value is the *primary* catalyst to any capital. Typically, traditional banks do not consider this type of investment, but venture capital and private equity firms are good do.

Below is a sample income statement for a company that we utilized to determine the Asset and DCF value.

Income Statement (in $MM)	Asset Value	DCF Value
Profit		
Total Income	$29MM	$29MM
Total Expenses	$16.8mm	$16.8MM
Net Profit	$12.2MM	$12.2MM
Other Assets		
Property (renting expense)	$-	$-
Inventory Value (wholesale)	$1MM	$1MM
Accounts Receivable	$2.5MM	$2.5MM
Cash On-Hand	$1MM	$1MM
Total Other Assets	$4.5MM	$4.5MM
Total Asset Value	**$16.7MM**	**$16.7MM**
12-Month Business Projection		
Net Profit		$24MM
Other Assets		$8MM
Total 12-Month Projection		**$48.7MM**

Note that the DCF Value evaluation is almost three times more than the Asset evaluation, $16.7MM vs. $48.7MM.

Most lenders and capital organizations start with these financials before they dig deeper into a business and look at other areas such as marketing, customers and distribution, growth potential, customer stability, owner and leadership dependability, cash flow impact (gross profit, cash requirements, past cash flow, and accounts receivable), and financials (over 3 to 4 years, if possible).

These evaluations are not an exact science, and, as in evaluating any prospectus, the outcomes of evaluations can fluctuate greatly. And sometimes, you can't just consider the numbers alone: Think Monopoly. If you currently own Boardwalk and you have an opportunity to purchase Park Place, you will have additional evaluations to consider.

About The Author

Paul Daigle is president of BizAdvisoryBaord, and co-founder of MSP Trusted Advisor Group and many more, also has served on 12 public, private boards and chairman of 6. He has owned his

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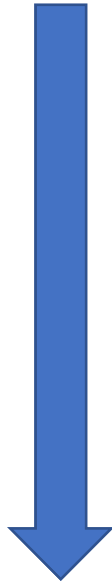
Extra Credit below (EBIDTA)



Extra Credit – EBIDTA

Vital in determining your equity value (less so for DCF valuations), your EBITDA is essential to determine the value of your company. What is EBITDA? **E**arnings **B**efore **I**nterest (financing structure) **T**axes **D**epreciation (investment decisions) **A**mortization. Below we will determine EBITDA for a sample company and utilize these numbers in both evaluations:

Income Statement ($MM)	2018 Year	EBITDA Calculation
Operating Revenues		
Service Revenue	$23MM	
Equipment Revenue	$6MM	
Total Operating Expense	$29MM	
Revenue		$29MM
Operating Expense		
Cost of Services	$5MM	$(5MM)
Cost of Hardware	$2MM	$(2MM)
Rent and Related Expenses	$1MM	$(1MM)
Selling, General, & Administration Expense	$4.5MM	$(4.5MM)
Net Income		$16.5MM
Depreciation and Amortization Expense	$2MM	$2MM
Provision for Taxes	$1.5MM	$1.5MM
Interest Expense	$8MM	$8MM
Total Operating Expense	$16.8MM	
EBIDTA		$20.8MM
Net Income (Revenue – Expenses)	$12.2MM	

In this example we are able to easily extract Revenue of $29MM, expenses of $16.8MM, and income at $12.2MM with an EBITDA of $20.8MM.

The EBITDA value is a good indicator for measuring a company's financial health as it evaluates a company's performance without taking into account economic and accounting decisions.