How to Arrive at a Realistic Valuation for Your Business

Meghan Daniels Axial | July 24, 2018

MMR: What's the top misconception CEOs have when it comes to valuation?

Mike: The fact of the matter is, many CEOs have no idea what their companies are worth. Some have unrealistically high expectations and others' expectations are too low. Both cases end up with them leaving a lot of money on the table. If they have unrealistically high expectations, they walk away from deals that they should be taking. If they have a valuation that's too low, very often they will grab the first deal that comes their way because they're flattered with the offer from the private equity firm that approached them.

MMR: How can sellers arrive at a realistic valuation?

Mike: They have to look at their company from the perspective of the buyer, not the seller. What's motivating the buyer to do the transaction? What kind of synergies are they looking for? It's important not to be fixated just on EBITDA multiples.

There are many instances where a buyer will pay significant premiums to gain a particular attribute. For example, a company might have intellectual property that's not reflected in the numbers but represents an area a buyer is looking to enter, or their company may have deep penetration in a specific geographic region that the buyer want to penetrate. There are many instances where foreign buyers are paying huge premiums to enter a particular U.S. market.

MMR: Are you seeing more foreign transactions today?

Mike: Yes. As many as 50% of our transactions have a foreign component to them. While we think of the U.S. economy as relatively slow growth, investors in places like Western Europe see the U.S. middle market as a desirable place to do business. If sellers look for potential buyers only domestically then they are really losing out on a lot of opportunities.

MMR: What’s another mistake you see CEOs make when it comes to valuation?

Mike: Often CEOs get a valuation for estate planning purposes which is solely based on EBITDA and as such is not a good indication of market value.

For example, we had a manufacturer of paint used for road striping. On the surface it seemed like a very simple business and one that would likely go to a strategic buyer, someone in the industry, either another paint manufacturer or a distributor. The typical industry multiple for this type of company was around six to seven times EBITDA. But this business had a key asset that really was not reflected in the EBITDA, and that is that they had relationships with Department of Transportation offices in almost all of the 50 states.

We had located a large foreign buyer, one of the largest manufacturers of road concrete in the world, who desperately wanted to enter into the U.S. market. They were willing to pay a huge premium to get those Department of Transportation relationships. The seller didn't necessarily appreciate the value of those relationships prior to the sale process. But when it came to the actual sale, the buyer paid as much for those relationships as they did for the EBITDA. Essentially they paid double the value of the company that would have been valued on a pure EBITDA basis.

MMR: At what point should a potential seller consult with an investment bank?

Mike: The earlier the better. We think of EBITDA as a range of multiples, and the question is why do some companies in the same industry sell at the lower range and others sell in the higher range. There are things that business owners can do to improve their multiple, but these things take time. For example, concentrations — customer concentrations, supplier concentrations — will result in a discount by buyers. Decreasing concentrations in either area takes time. If a business owner is thinking of selling in two or three years down the road, now's the time to be speaking to the appropriate professionals so you can identify these areas for improvement and create a strategy before you go to market.

MMR: How can sellers make sure a buyer is the right fit?

Mike: We think the due diligence process should go both ways. We encourage our sellers not to be intimidated and not to worry about spooking a buyer by asking a lot of questions. We encourage them to talk to strategic CEOs, as well as to the CEOs of private equity portfolio companies . The seller should ask questions about how the overall experience was with the buyer both during and post sale.

MMR: What kind of valuations are you seeing for the companies you represent?

Mike: We're seeing record or near-record valuations in just about every area we're in, even areas where you'd expect some softening like cyclical industries. Obviously it's been a long cycle. The expectation is that the cycle will continue for another year and a half or two years, and as a result we're not seeing any softening. There's a lot of money out there chasing relatively few deals. It's still a seller's market.

We know that all cycles come to an end, and when the cycle does end, two things happen. You have both a reduction in multiples, but you also typically have a reduction in EBITDA. Our advice to sellers right now is if they're considering selling in the next year or two, then perhaps they should take advantage of the strong market and consider expediting their plans a bit.