report

COMPANY VALUATION

by Danijel Pevec, Partner, Alpha Capitalis d.o.o.

BUSINESS OWNERS value their company for a number of different reasons: selling a company or parts of it, transferring a family business, transferring a company stake to management as a reward for a job well done, and many other reasons.

In accordance with the many existing reasons, there are also numerous methods that can be used to value a business. However, in this text, the focus will be on the two most commonly used valuation methods: Discounted Cash Flow method (DCF method) and valuation based on multiples.

It is important to note that not all methods will produce the same results – which method will be used depends on the type of business and many other factors. Also, making a credible company valuation requires a lot of thoughtful decisions as well as adequate financial analysis done by a valuation expert.

Below you can read more about the two most commonly used valuation methods.

DISCOUNTED CASH FLOW METHOD (DCF METHOD)

The discounted cash flow method is most commonly applied when the company's assets have the ability to generate income and when there are reasonable projections of future income for the assets in question.

In estimating the value of a company using discounted cash flows, the management of the company should first and foremost critically and reasonably consider the historical business and financial performance of the company, and, consequently, analyze the business environment within which the company operates. These steps are necessary as the valuation of the company depends on income projections for future periods, and this projection, in turn, depends precisely on the factors mentioned above.

There are 4 main steps in valuing the company using the discounted cash flow method:

1. Estimating free cash flow for the planning period (5 to 10 years)
2. Estimating the terminal value i.e. the value of the business beyond the forecasted period
3. Discounting free cash flow by the discount rate
4. Subtracting the net debt from the present value of free cash flow

The aim of this method is to determine the future cash flows of the company as accurately as possible, discount them at the appropriate discount rate to obtain the present value of those cash flows, and add them all up to get a single number.

BUSINESS VALUATION BASED ON MULTIPLES

This method is based on a comparison of the financial performance of a company being valued with the relevant market indicators. This approach to valuation is often used for the sake of simplicity and ease of calculation, and is generally used when quick valuation of the company is necessary. The most commonly used market indicators (multiples) are:

- Relation between the enterprise value and company's revenues (EV/Revenue)
- Relation between the enterprise value and company's EBITDA (EV/EBITDA)
- Relation between the enterprise value and company's EBIT (EV/EBIT)
- Relation between the Net income and number of share (EPS = Earnings per Share)

This method uses multiples of comparable companies for several future periods and multiplies them by the target company's indicators (Revenue, EBITDA, EBIT, net income).

The aim of this method is to find companies as similar as possible to the target company. Comparable companies should, first and foremost, resemble a valued company in risk level, current stage of a business cycle, and growth perspective.

The disadvantage of this approach is that a peer group can be fundamentally different from the target company which will eventually distort the accuracy of the valuation.

None of the valuation methods is considered optimal, that is, each method is characterized by different advantages and disadvantages. For example, the DCF method can analyze future cash flows qualitatively, but the parameters used in these methods are rather subjective, which can greatly affect the accuracy of projections of future cash flows.

On the other hand, valuation based on multiples is fast and simple, but also of a questionable accuracy. Therefore, the financial analyst in charge of business valuation should be unbiased, aware of the uncertainties, and highly educated, in order to effectively overcome these problems and successfully value a company.