HANSA PODCAST – EPISODE 002: HOW TO VALUE YOUR BUSINESS?

In our previous podcast we discussed the topic of getting better at thinking about capital. As a continuation of that topic today we will discuss valuation in more detail.

There are 2 main objectives from todays podcast – 1) most SME business owners read about start-ups and see the valuations of Unicorns on front pages of newspapers. They feel that they have operated for 15 years in the industry and are more profitable and set valuation expectations based on what they see in the news papers. We want to clarify why those valuations will most likely not apply to brick and mortar SME businesses. 2) is to improve the awareness of valuation among SME's. We have discussed valuations with about 50-60 companies in the last 2 years. Very few had even the basic knowledge about valuation.

We will present this topic in such a manner that someone with basic finance knowledge can also understand valuation and can value their company. Our valuation approach is meant for unlisted small and medium sized businesses.

Most SME business owners are happy with how their companies are currently operating. They are free to pay themselves as much salary as possible and dividend out as much money as they want each year. Only a few will genuinely want to take the company to the next level and are keen on building their net worth through the equity in the company. Valuation would become relevant to such people and to such companies.

To structure our discussion today about valuation we have divided it into 3 parts:

1. **First we will define the term 'valuation'** – we see a lot of confusion here with the different terms being used. When you read about start-ups you hear terms like 'Sales Multiple' or if you have been investing in listed companies you are aware of the P/E ratio. We will clarify the appropriate valuation metric for SME's and explain that in detail
2. **Second we will give you a practical approach on how to value your company** and arrive at a ball park number – this is the 'maths' part of valuation. There are several other factors that can have a significant impact on valuation – this forms the 'art' part of the valuation and we will briefly give you an overview of that as well
3. Third we will list all the mistakes that we see owners making in their companies that impacts valuation

Defining the term 'valuation'

When a business owner wants to know the value of his/her company, they will usually consult a trusted advisor. The advisor will do the valuation exercise for a fee. Most experienced and reputed advisors would do a good job and get you the necessary documentation to support the valuation.

When we meet companies and ask them the question – do you know what the company is worth? The answer is either 1) book value of equity as per the last audited balance sheet 2) some very high number which has no basis. Our objective today is to teach you a very simple way to answer such a question and also have some basis for setting initial valuation expectations. You will then be in a better position to discuss this topic with your advisors or investors.

The best metric that describes the overall value of a business is enterprise value also called EV. EV is a much better way of understanding the value of a business because it includes the shareholders value which is the 'Equity Value' it includes the debt in the company and also factors in the excess cash in the company.

EV is defined as (Equity + Debt – Cash) or (Equity + Net debt).

When someone says that my company is worth 100cr – then its always good to ask whether they are referring to the equity value or the enterprise value.

In the next section when we do an actual valuation exercise you will understand this in more detail.

Practical approach to valuation

I remember a conversation I had with the managing partner of my previous private equity firm. He said that 'At the end of the day valuation is an art. The maths part of it is simple but it takes many years of apprenticeship and many years of transaction experience to understand the art behind valuation'.

Lets first discuss the maths part of the valuation. There are 6 steps for you to get an initial valuation of your company:

Step 1: Identify 5-10 companies which are similar to your company and are listed on the local stock exchange. If you are in India then it will be BSE or NSE. Most owners know the listed companies in their domain.

Step 2: Go to this website like www.screener.in and search for the 5-10 companies that you have identified in step 1. You will have to register on this website with your email and its free. Once you have logged in you can search for any of the companies you have identified in step 1. When you get the data for a company, look for the field 'Add Quick Ratio'. In this field you can type 'EVEBIT' and that data will also start showing up in the company summary at the top. For all the 5-10 companies you can identify the 'EVEBIT' ratios. On this site you can also note the sales of these companies and the sales growth rates over 3 years.

Let me explain EVEBIT a little bit here. I have explained EV to you in the previous section. EBIT represents the earnings of your company after depreciation but before paying interest and taxes. It's a straightforward figure in your P&L. EVEBIT is the ratio of EV divided by EBIT.

I can give a long explanation on why EBIT and why not any other earnings figure like EBITDA or PAT etc, but it would get very technical and I would like to keep the discussion simple.

Step 3: Calculate the median of all the EVEBIT figures that you have gathered in step 2. Why Median and why not average? Because sometimes the ratios can be very high like 50x due to unusually low earnings or very low like 2x due to high earnings or even negative. A median will eliminate such figures and you will get the mid point.

Say the median EVEBIT is 9x. If all the listed companies are much larger then your company and are also growing faster than your company, then the ratio applicable to your company may be lower than the median. Lets say that the multiple applicable to your company is 8x.

Step 4: Get the EBIT figure from your last audited P&L. Say the EBIT is 10cr or 100 million

Step 5: The EV of your company is EBIT x EVEBIT = 10 x 8 = 80cr or 800 million

Step 6: Remember we told you that EV = Equity + Debt (Ignore cash for the moment). So the equity value in the company is equal to EV – Debt. Say debt in the company is 10cr or 100 million then the equity value is 80 – 10 = 70cr or 700 million

So in 6 steps you have an approximate value for the 100% of equity in the company.

We have covered the maths part of the valuation. Now lets discuss the 'art' part of the valuation. A good understanding of these will help you better follow valuations discussions and the chances of a transaction become realistic.

We have identified 10 elements that impact valuation. There are many more aspects that impact valuation. The 10 that we have today are:

1. **Earnings** (EBIT) – EBIT sometimes could be too high due to some one-offs or too low due to some write-offs. So the quality of the EBIT has to be understood in more detail. This analysis is called the 'Quality of Earnings' analysis.
2. **Growth rates** – Most important factor determining valuations are growth rates. Most start-up companies get very high valuations because they are growing at very high rates due to a disruptive technology and very little competition. SME's have much lower growth rates and operate in mature markets and hence expecting the same valuations is unreasonable. I am not justifying high start-up valuations here. There are clearly bubbles in start-ups like in 1999 and also to some extent now in 2019.
3. **Debt levels** – if the debt levels are too low that's always a positive sign but if the debt levels are high then one needs to understand if there are liquidity issues. Such scenarios will have a significant negative impact on valuation.
4. **Assets**: We reviewed an impact investment recently where the factory was worth 50cr but the land on which it was built was worth 5 times of that. In such cases its all about unlocking the value of the land. We have seen several companies located in and around metros which are experiencing this due to high land prices.
5. **Competitive advantage** – if the business has no competitive advantage then there is very little equity value in the business because the cashflows can very easily erode due to competition. Most SME business owners don't understand this. Such businesses are better off not raising equity and its best to milk them for dividends that they are generating.
6. **Team strength** – Most SME's run with very LEAN management teams and we also like that. But as the company is growing you need to also strengthen the company. This is one of the most challenging things for most owners to do. If the team is not adequate then the OPEX is lower than what it should be and hence the EBIT is higher.
7. **Working capital levels** – This is a slightly tricky point and even very experienced investment bankers struggle with this. Many businesses have a natural business cycle and sometimes the working capital levels are high and sometimes they are low. With that the working capital related debt also varies. If these swings are high it can have a substantial impact on the equity value. Note that EV of companies will not change due to business cycle. It's the debt that varies and hence the equity value.
8. **Contingent liabilities** – suppose there is a legal dispute that can potentially have a large claim on the company, you will have to factor that into the valuation
9. **Sum of parts** – sometimes businesses may have different divisions and one division can be large but with low growth but the other may be much smaller but fast growing. In such cases, each part can be valued separately to get the right value
10. **Market cycle** – Even stock markets have cycles and we are currently experiencing the peak of the stock market cycle in India. I maintain a graph where I track the P/E ratio of the index. That is currently at 26 which is a high number. If you keep this in mind then you know that the multiple you have estimated in the previous section is also high. Next year the market may be much lower than today.

We believe that setting realistic expectations will improve the chances of company getting funded and also improve the chances of a good return for the investors.

Common mistakes that erode valuation in companies

1. **'Low earnings = low taxes' mindset.** We have met many small business owners who think that high earnings will result in higher taxes so they never strive for higher earnings. They don't see the relation between earnings and valuation. If owners don't think about building net worth through equity creation, the company will continue at the todays performance levels.
2. **Driving growth through debt:** What most people don't understand is that EV = Net Debt + Equity. So when you take on debt in the company to fund growth the equity value gets squeezed.

Excess debt in the company becomes a limiting factor for growth and in extreme cases bankrupt the company.

3. **EBITDA or EBIT forms the basis for valuation** (if they are positive). Make sure they reflect the true earnings potential in the company. We saw a company recently where they tripled the salaries of owners prior to taking the decision of raising external capital. That reduces the EBIT and hence the impact on valuation is high
4. **Creating unrealistic growth plans** – Many growth plans are a theoretical exercise done by advisors to justify a high valuation. Many experienced investors just half the projections and evaluate the case. This needs a very different approach. Owners should atleast prepare a through budget for the coming year and prepare a 3 year growth plan with details of where the growth will come from and what are the resources required. They should start implementing that and show early results to make the plan realistic.
5. **Consolidated Earnings** – Sometimes the true earning potential of the company does not show up because of the consolidated figures of the company. We also touched upon this earlier. There are some innovative products in companies that are growing rapidly. Track the segment level financials separately – if possible down to the EBITDA level. You need to have proper accounting and costing routines to facilitate this.
6. **Not using Equity as an incentive** – Equity is almost never given as incentives to people who have played an instrumental role in building the company over several years. Most SME's are completely owned by a family and they remain that way. There are no incentives for professional to join the company and grow the equity value.