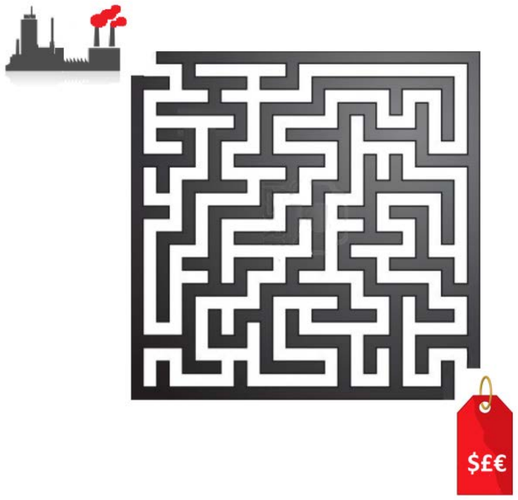
NEWSLETTER OF SYNAPSE

FOOD FOR BRAINS

Special Edition OIV-International Conference about Company Valuation (Università Bocconi-Milano - November 2013)

HOW MUCH IS MY BUSINESS WORTH ?

There are different situations during the existence of companies, where the crucial question arises: what is my business worth? The most obvious ones are, when decisions about ownership have to be made: going public, selling or buying partial or total ownership of a company, major refinancing exercises … Less obvious ones, especially for midsized companies, are linked to benchmarking the own company performance with the one of the competitors. Thorough supplier auditing can lead to valuation exercises as well.



For most of the very large companies on the market, well-structured and with complete reporting systems in place – including public reporting -, there are interlocutors of all kind, including and especially, the large accounting firms or corporate banks, who are able to make a good job on the subject of valuating a company with the adequate spending on their consultancy work.

But what about mid-sized companies, which are characterizing so many manufacturing industries in Germany, Italy and Turkey for example? The first reflex of management or owners in these areas is to speak to their accountant (Steuerberater, Commercialista, Tax Consultant….) and to get this exercise done by people they trust most, and who should know them best. More often than never, the work done by the “number-crunchers” isn’t generating a satisfying answer in terms of fair value. Even if “numbers don’t lie” as a banker once said to me, the facts behind the numbers are very often more important. Adequate valuation of the different assets of the company to come to a proper net worth altogether requires a series of adjustments – premiums or discounts – which can only be defined with an analyse, which goes far beyond computable data.

The risk is also, that the trusted accountants have often a vested interest in the valuation, as their services might be used, when it comes to selling shares or selling the company as a whole. The bias is obvious, and the risk of important valuation differences (in plus and/or in minus) to the fair value of the company are high.

Increasingly, mid-sized companies are asking independent consultants specialized in Mergers & Acquisitions to support their aim and work with them on the valuation of their business. This is what happens to our Consultancy with more regularity than in the past, and listening to our clients, it has to do with the important need to highlighting hidden valuation premiums and/or discounts.

In the nineties, in my past career as a pure M&A Consultant in the field of mid-sized industrial companies, it was my daily bread to do this kind of exercise. In that period in the history of European economy, things were all right. Chinese competitors were pointing the nose, but were not yet an identified threat to operators in mature markets. Globalization was starting to mean something serious to entrepreneurs, but more from the point of view of cheap sourcing and interesting emerging markets.

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Markets were behaving properly, budgeting made a sense for most enterprises and the future was known with relative precision for a whole fiscal year in advance or more.

Nowadays, a very large number of mid-sized companies don't know at the beginning of the month, what they will invoice at the end of the month. Incertitude, capacity to adapt and improvisation are the key-words, and not forecasting, budgeting and long range planning.

In periods of such incertitude, looking at the numbers achieved in the past to determine a fair value for a whole company or for its shares is a very risky exercise. Hard numbers are important, but to achieve a proper market valuation between a willing and informed seller and a willing and informed buyer, the analyse has to go very deep into operational aspects.

Our clients are requesting us increasingly to support them on that side, and I am pleased to share here some insights on the most recent developments on the valuation subject, gained during the International Conference on Company Valuation organized at the Bocconi-Universtiy in Milano by the OIV, a recognized body for standardization and trust-building in this very sensible field.

TRUST IS GOOD, CONTROL IS BETTER

Breached trust in valuation numbers was cited in this conference as one major factor of the recent financial turmoil. Trust is the main factor in getting a seller and a buyer to conclude a deal on an agreed value basis. Trust is the cement of judgement in Mergers & Acquisitions. So it is clear that trust in the involved persons - their quality, objectivity and professionalism -, and in the involved valuation process –the applied principles, the methods and the transparency -, are key to satisfactory transactions.

Whilst on the people side, trust is an intangible asset build-up via reputation over years, processes seem to generate less doubts, if they are sanctioned by some authorities. Organisms like OIV in Italy or IVSC in many countries are working hard on the subjects, developing and publicising recognized standardised processes, ethical rules and sanctioning the professionalism of valuators with competency frameworks and adequate certifications. Valuation, not being a fact, but a judgement, recognized skills and sanctioned processes will help increasingly to remove opacity from this professional specialization.

VALUATION SAFETY IN UNCERTAIN TIMES

To obtain higher safety and more certainty in company valuation, increasingly the different aspects of the business are evaluated by specialist valuators. Valuating liabilities (insurances, pensions…) require the involvement of adequate professionals. Valuating tangible assets require the use of other specialists. For most companies, the most valuable assets are the customers, the markets linked to them and the mostly intangible customer relationships.

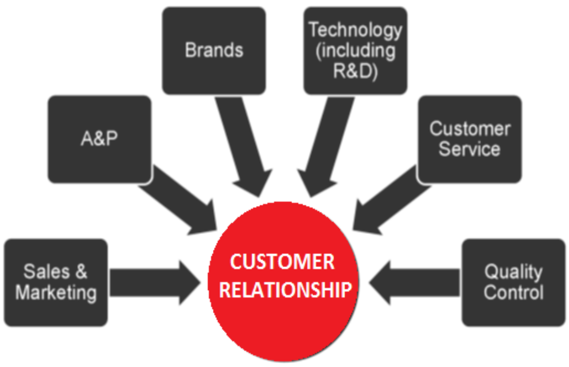

Illustration by PJ PATEL : Build-up of customer assets

Valuating this asset is a particular challenge, in times where predicting future customer behaviour can easier be a fortune-telling exercise, rather than an accurate forecasting process. Completely new aspects in valuation play an important role here, which require in-depth analyse and good understanding of the market itself. Understanding which part of the cash-flow generated by the business is linked to which of the customer relationship factors in the figure above and how strong these factors in the business are, represent some of the key interrogations to make.

Further on, it is crucial to understand where the existing customers are situated on the axis of commercial resilience and what is driving the value and the cash-flow of the business with those customers.

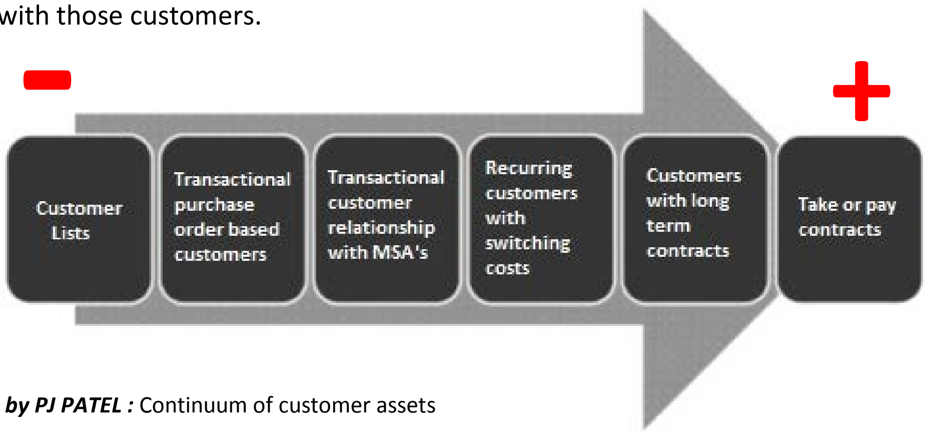

Illustration by PJ PATEL : Continuum of customer assets

For sure each individual industry has another susceptibility to the strength of the customer relationship. Barriers to change, linked to switching costs and stickiness, are to be understood and the so-called "artrition-rate" or "customer churn" has to be identified as well, in order to really allocate the right value to different customers. Last but not least, the performance of a business is often linked to aspects for which there is no tangible asset: scale and size of the business, location, specific expertise…a.s.o. Industry inherent cycles, specific technology and lurking disruptive innovations need further attention.

VALUATION BEYOND NUMBER CRUNCHING

The seller of a Company knows what he is selling. The buyer of a Company seldom knows what he is buying. This is an underlying principle to every company transaction. From my own experience in Mergers & Acquisitions, there is another adage which has full validity: sellers always overestimate the worth of their business, optimistically projecting flowery future perspectives, whilst buyers always drive the worth of a business down in their estimates, having limited visibility and higher risk-aversion, and calculating returns-on-investments before dreaming of a future business explosion. Analysing the risks is the most important part of valuation and variability of cash flow is the risk factor.

To come to the fair value of a business, raw balance sheet data of assets are subjected to premium- and discount analyses. The soft factors behind the numbers need in-depth analyse and this exercise requires long lasting experience, business acumen and social intelligence. Current and future economic uncertainty will increase the need for "Valuation 2.0". And valuation with regular benchmarking against the competition might become a management tool, even and in particular for mid-sized industrial companies, as this type of exercise will, beyond the pure determination of a number, help to highlight areas of improvement - where discounts seem necessary - and point out areas of excellence - where premiums are identified -, for management and shareholders to improve their activity and leverage strength for the future development of the business.

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