Valuing Companies With Erratic Earnings

What is the right metric?

A significant number of businesses that come to market do not have consistent stream of earnings. Inconsistent earnings history makes it difficult for acquirers to predict future earnings and create a valuation challenge. Using an "industry earnings multiple", the most common metric used to value mid-market companies can be meaningless in these situations.

Which earnings number does one pick? The highest? The lowest? Most recent? The average? Weighted average?

On the surface, using weighted average may seem like an appealing answer. However, using weighted average typically leads to overvaluing or undervaluing the company by a substantial margin to the detriment of either the acquirer or the seller.

Assuming a reasonable earnings number can be picked using weighted averages, is "industry earnings multiple" a valid multiplier to arrive at a valuation? In not, how does one value these companies?

A keen appreciation of financial methods and industry knowledge are essential to answer these questions. The first step in the process is to gain a clear understanding of the reasons for the earnings variability. Some common reasons for earnings variability are:

- Economic changes in the target market
- Development phase of the company
- Large non-recurring income/expenses
- Loss/gain of large customers
- Entry/exit of major competitors
- Changes in management or key employees
- Changes in physical environment and target market
- Substantial changes in level or amount of operating equipment or people
- Changes in COGs that are out of line with changes in final product/service prices

Acquirers may see some of these reasons as problems that reduce the future earnings. They may also see some other reasons as opportunities that increase the future earnings. It is imperative that both the reasons and the impact be well understood early in the valuation process. Once the reasons are identified and their impact assessed, appropriate adjustments can be made to recast the financials to get a more meaningful picture of the company's revenue and earnings stream. Quite often, these recasted numbers indicate a stable or predictable earnings or revenue stream.

If the earnings stream is predictable, the acquirer can use industry price/earnings multiples to arrive at a reasonable valuation.

If the earnings stream is somewhat erratic but the revenue stream is predictable, the valuation may have to rely more heavily on industry price/sales multiples.

If neither the earnings nor the revenues are predictable after recasting, the valuation process becomes highly subjective. In such a situation, the transaction price should either show a substantial discount to a market multiple or be tied to future performance of the business.

Chak Reddy is a Mergers and Acquisitions Advisor with Elite Mergers & Acquisitions, Inc. Elite Mergers & Acquisitions specializes in selling California Central Valley businesses with revenues between $1 million and $100 million - Businesses too large for business brokers to adequately handle but too small for the national M&A firms. Mr. Reddy is a business M&A and Marketing expert, and is the chief deal maker at Elite. You can reach Mr. Reddy at 916-220-3052 or by email at creddy@elitemanda.com .

For assistance with selling or recapitalizing your mid market company, contact:

Chakradher (Chak) Reddy

Elite Mergers & Acquisitions

creddy@EliteMandA.com   www.EliteMandA.com

11707 Fair Oaks Blvd, Suite 201, Fair Oaks, CA 95628

Ph: 800-335-3068; Fax: 888-502-3817

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