

FOR EXECUTIVES SEEKING TO BUY, SELL, OR RECAPITALIZE BUSINESSES

## Valuing Growth Companies

### The folly of industry multiples

I routinely see individual buyers coming up with low valuations for growth businesses based on simple multiple of the most recent year's profitability and, worse yet, based on a multiple using a weighed average of the profits from the preceding 3 years. I usually offer them this simple way of looking at the problem.

Let's take the example of 3 different businesses with identical last 12 month revenues and earnings:

- ❖ Business1 has a history of cash flow growth of 10% over many years and the target market is continuing to grow.
- ❖ Business2 has a history of a steady cash flow for a long time with relatively minor variation from year to year and the target market is a stable.
- ❖ Business3 has a history of steadily declining cash flow for the last several years and the market outlook appears to be unfavorable.

Using industry standard multiple of most recent year's earnings, all these business are valued the same. Would you value these businesses at the same level? Of course, not!

How about using multiple based on weighed average of last 3 years profits? A quick check would show that this would lead to the conclusion that Business3 has the highest valuation and Business1 the lowest valuation! In most scenarios, this answer would be preposterous!!

So, why did industry multiples and weighed averages give wrong results for these companies? How can you value these companies? I will cover the answer to the former question in a different blog entry. For now, let's focus on how you can better value these companies.

Setting aside the strategic or synergistic value of these companies, there are a couple of good answers to this question:

- ❖ Use Gordon Growth model to arrive at a growth adjusted value of the earning stream.

$$V = E / (R - G)$$

Where: V = Value of a company

E = Annual earning stream

R = Required rate of return

G = Projected long term growth rate of the Earning Stream

- ❖ Develop a forecast of long term earnings stream and conduct scenario analysis based on discounted cash flow. This method is more sophisticated and requires spreadsheet skills but can be useful in establishing a range of values under different scenarios.

The valuation arrived by these methods gives acquirers a reasonable starting point in many small to mid-market business acquisitions. The acquirer should be aware that the real value of these companies has more to do with the strategic or synergistic value of these companies and can be much higher than what these simple methods suggest. We will cover this topic in a different article.

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](mailto:creddy@elitemanda.com).

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

Chakradher (Chak) Reddy

Elite Mergers & Acquisitions

[creddy@EliteMandA.com](mailto:creddy@EliteMandA.com)

[www.EliteMandA.com](http://www.EliteMandA.com)

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

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

*Disclaimer: This document is for informational purpose only and should not be construed as tax or legal advice. Please contact your CPA/attorney for advice on your specific situation.*