Avoiding Common Seller Mistakes in Mergers & Acquisitions - Understanding Valuation

sales solution

by Brooke Hollis

This issue will look at a few issues regarding valuation of a staffing company. The next issue will look at some strategies to improve value prior to a potential sale.

Valuation — An Art and A Science

Owners are always asking, "What is my business worth?" The answer is, "It depends." Why? Because value is relative. Valuations are done for different purposes. Is the company being sold in whole or in parts? Is it a partner who is being bought out? Is the goal to merge with another and focus on "upside" value as you grow together? Is the business being valued for estate planning purposes, for conversion from a "C" to and "S" corporation, etc.? The more important question might be, "What is the maximum amount a buyer would pay?"

This article will focus on value for sale to an outside buyer. So, how does a buyer value a potential acquisition? Ultimately, buyers must economically justify the purchase price they pay. They must be comfortable that the business will be able to generate sufficient cash to yield a reasonable rate of return on the investment made while servicing any debt taken on to finance the purchase price. While there are a number of valuation approaches, determining value is an art and not just a simple formula.

Multiples of Earnings or Capitalization Rates

Typically staffing services business buyers are seeking to purchase a continuing stream of cash flows with some measure of certainty. Each business has a different level of variability in historical earnings, and may have risk factors such as customer concentration, key employees who may not stay, 1099 versus W-2 employees, etc. The buyer's confidence in the future can vary substantially from business to business.

A simplified method of looking at the future stream of cash flow is to use a multiple of earnings or capitalization rate. The advantages of these methods are that they are simple on the surface. They can also approximate a return on investment. Theoretically if the buyer requires a 25 percent pretax return, this would equate to a four multiple, or a 25 percent capitalization rate. Staffing and other services business valuations typically tend to fall in a range that may be somewhat lower or somewhat higher than this level — depending on the particular company and market conditions.

The challenge is both which earnings numbers to use, and to choose the proper multiple or cap rate. For example, cash flow or earnings can be expressed a variety of ways:

- Net Income (after tax on many financial statements),
- Pre-tax Income,
- Earnings Before Interest and Taxes (EBIT),
- Earnings Before Interest Taxes Depreciation and Amortization (EBITDA), or
- Free Cash Flow

Earnings should then be adjusted for items such as unusual one-time expenses, excess owner compensation, etc., to determine true earnings. This can be complicated and must be defensible, as often a buyer will disagree with seller adjustments.

In addition to the above, the structure of the transaction can make a significant difference. Some factors consider:

- Treatment of receivables or other balance sheet items
- The tax consequences of a stock versus asset purchase
- Whether an "earn-out" is part of the price
- Amounts in cash, stock, notes etc.
- Guarantees, puts/calls etc.

For a more detailed discussion of multiples, please see reference (1).

Discounted Cash Flows and Reality

Most buyers use a more sophisticated acquisition valuation model that factors in a variety of factors beyond the simplified multiples of earnings noted above. Buyers make assumptions about future streams of earnings and use a discount rate to bring this back to today's terms. They also add a variety of variables including risk factors, potential economies of scale, synergies/potential for savings, cross-selling, and complementary clients etc.

In the end, however, it is not the valuation approach used but what willing buyers offer that represents current market value. Since different buyers have different needs and risk tolerances, we have sometimes seen dramatic differences in offers made for the same staffing clients. One cannot assume who will be the best buyer. Just because someone bought in the past is not an indicator, or willingness, or ability to buy now. While strategic buyers often pay more than others, private equity groups have been very competitive in the past few years. They may also offer some attractive "upside" opportunities for the right seller. So there is no one simple answer.

Bottom Line

The real key to maximizing value is to be talking in parallel with a number of buyers. This encourages the best offers that can be made so sellers can choose the best total package available at the time, including price, structure, and cultural fit for your organization. Staffing firms would be wise to work with a team that assures having adequate alternatives to optimize value so the owners can make the best decision for their particular circumstances.

(1) Lyons, Jack "The Illusion of Multiples" in the ASA publication *Staffing Success* March-April, 2005 pp 47-50.

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