



## # 4 How to Value a Private Company

The average Price Earnings ratio for the largest **public** companies on the London Stock market stood at 16.29, 26.12 and 8.74 on March 1<sup>st</sup> 1997, on September 20<sup>th</sup>, 2000 and on Dec 11<sup>th</sup>, 2008 respectively (A PE ratio is the number of years of post tax profits a company is worth). Therefore faced with valuing a **private** company, let's say, the objective is to buy it, how would you solve the problem? Use a PE ratio? But which one, which sector, which country and at what date?

Let's look at a framework for valuing private companies. Every sector uses specific rules of thumb alongside the traditional methods. In the software sector that special rule: valuations equate to a **multiple of sales**. Using a worked example let me demonstrate how a buyer might value the private US software company, Smithforce, which is in the security infrastructure space.

Firstly the psychology; sellers can't value businesses, only buyers can. Sellers **aspire** to price, buyers **perceive** value. Each buyer stands in their unique footprint of value, looking at the post acquisition value through their lens. The acquirer has established some key facts on Smithforce and US Public company comparables.

Smithforce has an adjusted historical post tax profit of \$4.6m, historical EBITDA (profits pre interest, depreciation, amortization and tax) of \$6m, trailing 12 months sales of \$25m, net assets of \$1.4m. Future pre tax profits accruing to the buyer over the next 5 years are \$7m, \$9m, \$12m, \$15m, and \$20m. Capital expenditure is negligible. Research suggests that the "infrastructure sector of software" for public companies trades at a ratio of Valuation: EBITDA of 8.98 and a Valuation: sales ratio of 1.67 (real numbers from a recent Corum report). Let us assume Smithforce has a direct Public company competitor, which is ten times larger, that trades at a PE ratio of 30, EBITDA ratio of 9 and a trailing sales ratio of 2.52. Similar acquisitions to Smithforce completed in the last 12 months, whilst virtually unusable in a declining market, let's say show on average, prices paid to sales ratios of 1.8.

			November-08	Discount	Valuations
	Basis	Source	Ratios	40% (Note 1)	\$m
1	Sales	Public Company averages	1.67	1.002	25
2	Sales	Specific Public Company Competitor	2.52	1.512	38
3	Sales	Previous relevant transactions	1.8	1.8	45
4	EBITDA	Public Company averages	8.98	5.388	32
5	EBITDA	Specific Public Company Competitor	9	5.4	38
6	Post tax	Public Company averages	12.49	7.494	34
7	Post tax	Specific Public Company Competitor	30	18	83
8	DCF	Use Discount rate 20%			34
9	Net Assets	Target's balance sheet			1.4

(Note 1: Private company valuations **can** attract discounts of 25-50% to reflect risk, lack of liquidity and scale)



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### **Interpretations and Conclusions**

Here is where art meets science: I would lean heavily on lines 1, 4, 6 and 8, as highlighted, giving a range of \$25m to \$34m. In today's declining market, line 3 is optimistic and out of touch. A valuation derived from much larger competitors, lines 2, 5 and 7, won't fly. Line 9 tells you how much goodwill you've just paid! Factors that would influence me include – dependence on a few customers, level of owner benefits, exceptional costs or gains, historical growth rates, quality of product pipeline, IPR, competence of second tier management, competitive profit margin, market share, sales pipeline, simple share structure and compliant GAAP in place.

Of course a company, like a house is only worth what a buyer will pay and that is where the comparison with house buying ends.