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Accounting For Value Creation

In many of our conversations with private business owners, initial valuation discussions are typically focused on EBITDA. There is a conventional wisdom in the middle market that valuation is driven by EBITDA and the larger the amount, the higher the valuation multiple.

The reality is that valuations are much more complex and are primarily a function of the underlying fundamentals of a business. These fundamentals might include growth opportunities, recurring revenues, customer and product diversity, entry barriers, proprietary products and high levels of free cash flow. Our experience tells us that different buyers can have widely divergent views of value based on their relative assessments of these underlying fundamentals.

One outcome is always clear, however, buyers will assign higher multiples to revenues and EBITDA that are more recurring in nature, that are less exposed to changes in levels of economic and industry activity, and that require minimal capital expenditures to maintain.

Many of our clients have diverse businesses that exhibit one or more of these characteristics. A perfect example is a company that performs both construction and maintenance work in a specific market segment. Buyers will assign a higher valuation multiple to the EBITDA associated with the recurring maintenance work than to the EBITDA associated with the periodic construction work. It is important for private business owners to understand valuation drivers and to develop the financial and operating data that will enable buyers to properly assess the underlying fundamentals of their businesses. More clarity for a buyer leads to a higher level of confidence and a more attractive valuation for the seller.

A challenge for private business owners is capturing the correct data to assess the underlying fundamentals of their business, which may not be easily derived from a typical software package designed to create GAAP-based financial statements. Time and time again our clients are unable to accurately respond to data requests from potential buyers because

Alan Blackburn, Managing Director GulfStar Group

they never thought about capturing the information that potential buyers may require. Buyers of privately held businesses are going to dig much deeper into the fundamentals of a business than what they can typically discover through a review of conventional financial statements. Several examples of recent clients can demonstrate this point.

Company A manufactures proprietary products for which there were substantial new and replacement applications. The new applications are a function of industry activity but the replacement applications are a function of wear-and-tear.

The first question every buyer asks is how much of the company's revenues are associated with new applications and how much are associated with replacement applications. A high percentage of replacement revenues would imply more recurring, non-economically-sensitive revenue streams and thus command a higher multiple. The challenge was that the company had never developed the data to answer this question. Since there was no way to go back in time to develop this information, the company's valuation multiple potentially suffered as a result.

Company B performs oil and gas well site construction and maintenance services for a wide range of customers. Some of these services are associated with maintaining existing oil and gas production facilities and some of these services are associated with constructing and installing new oil and gas production facilities.

Again, potential buyers immediately want to dig into how much of the company's revenues are associated with ongoing maintenance activities that would not be affected by commodity prices or levels of drilling activity. As the company performs both types of services for each of its customers, there is no easy way to delineate this information by customer. Increasing certainty with respect to the level of ongoing maintenance revenues leads to a higher valuation multiple. Uncertainty creates risk which leads to a lower valuation multiple.

Company C provides rental equipment that is subjected to significant wear-and-tear. While customers are required to pay for repairs, ultimately the company has to replace the equipment in the rental fleet.

The first question potential buyers ask is how much of the company's cash flow has to be reinvested into the rental fleet in order to maintain the current revenues of the business. Significant levels of reinvestment would reduce levels of free cash flow and negatively impact the potential valuation multiple. Tracking which capital expenditures are for the growth of the business and what capital expenditures are required to maintain the existing business is important for every private business owner that is considering selling a business.

While EBITDA levels certainly matter, there is a lot more that goes into the valuation of a business. Every owner of a privately held business should spend the time to understand what factors ultimately drive the valuation of their business, and then develop information systems designed to capture the operating and financial data related to these factors for potential buyers. The outcome will not only yield a higher valuation multiple but a more seamless and less stressful sale process.

ablackburn@gulfstargroup.com